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## RECENT DEVELOPMENTS IN THE LAW OF BANKRUPTCY: ANALYSIS OF RECENT EIGHTH CIRCUIT DECISIONS

### INTRODUCTION

In the eighteen month period from July 1984 through December 1985 the Eighth Circuit Court of Appeals decided thirty-three cases<sup>1</sup> construing the Federal Bankruptcy Code.<sup>2</sup>

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1. The cases dealing with bankruptcy issue decided by the Eighth Circuit Court of Appeals during this 18 month period are: *F & M Marquette Nat'l Bank v. Richards*, 780 F.2d 24 (8th Cir. 1985); *Lend Lease v. Briggs Transp. Co. (In re Briggs Transp. Co.)*, 780 F.2d 1339 (8th Cir. 1985); *U.S. v. Brimberry*, 779 F.2d 1339 (8th Cir. 1985); *Garland Coal & Mining Co. v. United Mine Workers of America*, 778 F.2d 1297 (8th Cir. 1985); *Stevenson v. Stevenson Assocs., Inc. (In re Stevenson Assocs., Inc.)*, 777 F.2d 415 (8th Cir. 1985); *Barclays American/Business Credit, Inc. v. Long (In re Long)*, 774 F.2d 875 (8th Cir. 1985); *Vreugdenhil v. Hoekstra*, 773 F.2d 213 (8th Cir. 1985); *Barclays American/Business Credit, Inc. v. Leonard (In re Standard Conveyor Co.)*, 773 F.2d 198 (8th Cir. 1985); *N.S. Garrott & Sons v. Union Planters Nat'l Bank of Memphis (In re N.S. Garrott & Sons)*, 772 F.2d 462 (8th Cir. 1985); *Jennen v. Hunter (In re Hunter)*, 771 F.2d 1126 (8th Cir. 1985); *U.S. v. Nat'l Store Fixture Co. (In re Nat'l Store Fixture Co.)*, 769 F.2d 1334 (8th Cir. 1985); *Basin Elec. Power Coop. v. Midwest Processing Co.*, 769 F.2d 483 (8th Cir. 1985); *Bankers Trust Co. BT Serv. Ct. v. Nordbrock (In re Nordbrock)*, 772 F.2d 397 (8th Cir. 1985); *Clarkson v. Cooke Sales & Serv. Co. (In re Clarkson)*, 767 F.2d 417 (8th Cir. 1985); *Fossum v. Federal Land Bank (In re Fossum)*, 764 F.2d 520 (8th Cir. 1985); *NLRB v. Superior Forwarding, Inc.*, 762 F.2d 695 (8th Cir. 1985); *Yamaha Motor Corp. U.S.A. v. Shadco, Inc.*, 762 F.2d 668 (8th Cir. 1985); *Mixon v. Anderson (In re Ozark Restaurant Equip. Co.)*, 761 F.2d 481 (8th Cir. 1985); *Martin v. U.S. (In re Martin)*, 761 F.2d 472 (8th Cir. 1985); *Prudential Ins. Co. v. Monnier (In re Monnier Bros.)*, 755 F.2d 1336 (8th Cir. 1985); *Armstrong v. State Bank of Towner (In re Gelking)*, 754 F.2d 778 (8th Cir.), *cert. denied*, 105 S. Ct. 3529 (1985); *Dahlquist v. First Nat'l Bank (In re Dahlquist)*, 751 F.2d 295 (8th Cir. 1985), *on remand*, 53 Bankr. 428 (1985); *Mann v. McCombs (In re McCombs)*, 751 F.2d 286 (8th Cir. 1984); *U.S. v. Arlon Indus. (In re Sepco, Inc.)*, 750 F.2d 51 (8th Cir. 1984); *In re Thompson*, 750 F.2d 628 (8th Cir. 1984); *Brown v. First Nat'l Bank*, 748 F.2d 490 (8th Cir. 1984); *Commissioner of Internal Revenue v. DeLeve*, 748 F.2d 465 (8th Cir. 1984); *Cassidy Land & Cattle Co. v. Commercial Nat'l Bank & Trust Co. (In re Cassidy Land & Cattle Co.)*, 747 F.2d 487 (8th Cir. 1984); *Button Hook Cattle Co. v. Commercial Nat'l Bank & Trust Co. (In re Button Hook Cattle Co.)*, 747 F.2d 483 (8th Cir. 1984); *Kotts v. Westphal*, 746 F.2d 1329 (8th Cir. 1984); *Carlson v. Farmers Home Admin. (In re Newcomb)*, 744 F.2d 621 (8th Cir. 1984); *Boyd v. Robinson*, 741 F.2d 1112 (8th Cir. 1984); *Missouri ex rel. Ashcroft v. Cannon (In re Cannon)*, 741 F.2d 1139 (8th Cir. 1984); *Brookfield Prod. Credit Ass'n v. Borron*, 738 F.2d 951 (8th Cir. 1984); *Citizens State Bank v. Davison (In re Davison)*, 738 F.2d 931 (8th Cir. 1984); *First Fed. Sav. & Loan Ass'n v. Hulm (In re Hulm)*, 738 F.2d 323 (8th Cir.), *cert. denied*, 105 S. Ct. 398 (1984).

2. Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (codified as amended at 11 U.S.C. §§ 101-151326 (1982)); Bankruptcy Amendments and Fed-

This survey will discuss significant developments concerning fraudulent conveyances; the allocation of payment between nondischargeable and dischargeable debts; nondischargeability of debts for malicious conversion; avoidance of liens created upon marriage dissolution; adequate protection; and other significant developments. The purpose of this survey is to analyze recent bankruptcy trends in the Eighth Circuit and their importance to the practitioner.

## I. FRAUDULENT CONVEYANCES: THE CONTINUING DEBATE ON FORECLOSURE AS A TRANSFER OF INTEREST WITHIN SECTION 548

### A. *Fraudulent Conveyance*

In 1980, the Fifth Circuit Court of Appeals handed down a remarkable decision<sup>3</sup> that changed the doctrine of fraudulent conveyance under the Bankruptcy Code.<sup>4</sup> Prior to that decision, no court had addressed the issue of whether a regularly conducted foreclosure sale could be set aside as a fraudulent conveyance.<sup>5</sup>

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eral Judgeship Act of 1984, Pub. L. No. 98-353, 98 Stat. 333-92 (codified at scattered sections of 11 U.S.C. and 28 U.S.C.) (Supp. II 1984).

3. *Durrett v. Washington Nat'l Ins. Co.*, 621 F.2d 201 (5th Cir. 1980). The *Durrett* decision was remarkable in that it represented a distinct departure from clearly established assumptions about secured transactions. Prior to the development of the fraudulent conveyance doctrine, it had generally been perceived that "a transfer of property ha(d) taken place at the time a secured creditor perfect(ed) its interest in a debtor's assets." E. Berman & J. Fierberg, *Durrett: The Problem and Suggestions for its Solution*, 90 Com. L.J. 162 (April 1985). The *Durrett* case was the first to reject that notion. *Id.* at 162.

4. The *Durrett* case held that a regularly conducted foreclosure sale constituted a transfer within the meaning of the existing bankruptcy law. *Id.* at 204; see Chandler Act, Pub. L. No. 575, 11 U.S.C. § 107(d) (1976) (repealed 1978). The old bankruptcy act defined a transfer as "the sale and every other and different mode, direct or indirect, of disposing of . . . property . . . ." 11 U.S.C. § 1(30) (1976) (repealed 1978). The court in *Durrett* found that receipt of approximately 70% of the fair market value of the property at the foreclosure sale was insufficient. *Durrett*, 621 F.2d at 204. See generally W. Henning, *An Analysis of Durrett and its Impact on Real and Personal Property Foreclosures: Some Proposed Modifications*, 63 N.C.L. REV. 257 (1985) (discussing usefulness of *Durrett* fraudulent transfer theory).

5. See Henning, *supra* note 4, at 258. Throughout the development of the doctrine of fraudulent conveyances, however, few people anticipated the creation of the doctrine represented in *Durrett*. *Id.* at 257. See also *Abramson v. Lakewood Bank and Trust Co.*, 647 F.2d 547, 550 (5th Cir. 1981) (Clark, J. dissenting), *reh. denied*, 655 F.2d 1131, *cert. denied*, 454 U.S. 1164 (1982). Judge Clark stated that "[i]t is interesting to me that *Durrett* is the first case treating this problem—after 90 years of bankruptcy law and mortgage of a time greater than the memory of man. It again

Since *Durrett*, this area has been actively litigated.<sup>6</sup> Three basic theories have emerged that interpret this developing doctrine.<sup>7</sup> The Eighth Circuit court recently entered the fray for the first time with its decision of *In re Hulm*.<sup>8</sup> In *Hulm*, the court held that a regularly conducted, noncollusive, judicial foreclosure sale constitutes a transfer within the meaning of section 548.<sup>9</sup> Further, the court held that there is no presump-

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establishes what an imaginative lawyer can do when he adds persuasion." *Id.* For further discussion of the effects of *Durrett*, see Berman & Fierberg, *supra* note 3, at 162; L. Coppel & L. Kann, *Defanging Durrett: The Established Law of "Transfer"*, 100 *BANKING L.J.* 676 (1983).

6. See, e.g., *Madrid v. Lawyers Title Ins. Corp.* (*In re Madrid*), 725 F.2d 1197 (9th Cir.) (noncollusive, nonjudicial foreclosure sale is not fraudulent transfer), *cert. denied*, 105 S. Ct. 125 (1984); *Abramson*, 647 F.2d 547 (remand to determine if transfer fraudulent); *Durrett*, 621 F.2d 201; see also *Rueback v. Attleboro Savings Bank* (*In re Rueback*) 55 *Bankr.* 163 (*Bankr. Mass.* 1985); *In re Upham*, 48 *Bankr.* 695 (*Bankr. N.Y.* 1985); *Hoffman v. Heritage Savings & Loan Ass'n* (*In re Garrison*), 48 *Bankr.* 837 (*D. Colo.* 1985); *White v. Luton* (*In re White*), 47 *Bankr.* 98 (*Bankr. Tex.* 1985); *Gillman v. Preston Family Invest. Co.* (*In re Richardson*), 23 *Bankr.* 434 (*Bankr. Utah* 1982).

7. The first theory, which is represented by the *Durrett* case states, in essence, that a foreclosure sale is a transfer within the meaning of the Bankruptcy Code and that the price paid at the foreclosure sale is prone to attack on the ground of insufficient consideration. See *Durrett*, 621 F.2d at 203-04; see also (*In re Hulm*), 738 F.2d at 326-27; *Abramson*, 647 F.2d at 549.

The second theory holds that no transfer occurs at the foreclosure sale. The transfer occurs at the time the security interest in the property is perfected (i.e. recorded) under state law and that the foreclosure sale is merely an event of change of possession rather than a transfer of ownership. See *Madrid*, 725 F.2d at 1200-01; see also *Abramson*, 647 F.2d at 549 (Clark, J., dissenting) ("mortgagor-trustor/bankrupt does nothing but default — that cannot be translated into 'transfer'").

The third theory recognizes that a transfer occurs at the foreclosure sale, but holds that the price paid at the sale is presumptively adequate absent defects in the sale. Cf. *Madrid v. Lawyers Title Ins. Corp.* (*In re Madrid*), 21 *Bankr.* 424 (*Bankr. 9th Cir.* 1984), *aff'd on other grounds*, 725 F.2d 1197.

8. 738 F.2d 323 (8th Cir. 1984), *cert. denied*, 105 S. Ct. 398.

9. *Id.* at 327. Section 548 states, in pertinent part:

(a) The trustee may avoid any transfer of an interest of the debtor in property, or any obligation incurred by the debtor, that was made or incurred on or within one year before the date of the filing of the petition, if the debtor

(1) made such transfer or incurred such obligation with actual intent to . . . defraud any entity of which the debtor was . . . indebted; or

(2)(A) received less than a reasonably equivalent value in exchange for such transfer or obligation; and

(B)(i) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation;

. . .

(d)(1) For the purposes of this section, a transfer is made when such transfer becomes so far perfected that a bona fide purchaser from the debtor against whom, such transfer to be perfected cannot acquire an

tion of adequate consideration for the transfer.<sup>10</sup> Subsequent to *Hulm*, the Bankruptcy Code was amended, in effect affirming the Eighth Circuit's view on the issue of transfer.<sup>11</sup> This section addresses the history of the doctrine of fraudulent conveyance, the *Hulm* case in light of that history, the impact of the 1984 amendments on the issue, and an alternative solution in light of economic realities and business expectations.

### B. The *Hulm* Decision

The common law concept of fraudulent transfer required that, in order to avoid the transfer, the debtor must have a specific intent to defraud the creditor.<sup>12</sup> Eventually, the concept of fraudulent conveyance developed to where actual intent became irrelevant.<sup>13</sup> The conveyance could be avoided if it had the effect of defrauding creditors.<sup>14</sup>

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interest in the property transferred that is superior to the interest in such property of the transferee . . . .

11 U.S.C. § 548 (1982 & Supp. II 1984); see also 11 U.S.C. § 101(48) (Supp. II 1984) (provision amends former section 101(41)).

10. 738 F.2d at 327. "We disagree with the approach taken by the bankruptcy court." *Id.* "We do not believe that the sale price at a regularly conducted foreclosure sale, although absent fraud or collusion, can automatically be deemed to provide a reasonably equivalent value in exchange for the interest of the debtor transferred within the meaning of section 548(a)." *Id.*

11. Section 101 defining transfer was renumbered in the 1984 Bankruptcy Amendments and Federal Judgship Act, Pub. L. No. 98-353, §§ 391, 401, 421, 98 Stat. 333, 364, 366, 368 (codified at 11 U.S.C. § 101 (48) (Supp. II 1984)). Section 548 was amended by the addition of the words "whether voluntarily or involuntarily" at the end of clause (a). *Id.* § 463, 98 Stat. 333, 378; see also *supra* note 7.

12. See Henning, *supra* note 4, at 259-60. In his article, Professor Henning thoroughly discusses the history of the fraudulent conveyance doctrine from the sixteenth century to the present. *Id.*; see also S. Alden, S. Gross & P. Borowitz, *Real Property Foreclosure as a Fraudulent Conveyance: Proposals for Solving the Durrett Problem*, 38 Bus. Law. 1605, 1605 (1983) (purpose of fraudulent conveyance law was to prevent deliberate action which hinders, delays or defrauds creditor); Note, *Regularly Conducted Non-collusive Mortgage Foreclosure Sales: Inapplicability of Section 548(a)(2) of the Bankruptcy Code*, 52 FORDHAM L. REV. 261, 264-65 (1983) (at common law, transfers voided if intentionally fraudulent).

13. Henning, *supra* note 4, at 260. As Professor Henning points out, it was difficult to prove subjective fraud. To remedy this problem, courts developed the concept of outward manifestations of fraud or "badges of fraud." See *id.* By the twentieth century, the law was "in a confused, disorganized state." *Id.* In 1918, the Uniform Fraudulent Conveyance Act was approved in an attempt to alleviate the confusion.

14. See, e.g., UNIF. FRAUDULENT CONVEYANCE ACT § 4, 7A U.L.A. 474 (1918). The Uniform Fraudulent Conveyance Act (UFCA) was first formulated in 1918. *Id.* It adopted the basic premises of the English concept, but removed the requirement of intent to defraud. *Id.* The Uniform Fraudulent Conveyance Act has been succeeded

The concept of fraudulent conveyances was addressed in modern bankruptcy law in section 67(d)(2) of the Chandler Act, the predecessor of the Bankruptcy Code.<sup>15</sup> The concept of a fraudulent conveyance, which originally included only voluntary transfers made by the debtor, was broadened to include involuntary transfers.<sup>16</sup> In 1978, the Bankruptcy Reform Act replaced section 67 with section 548.<sup>17</sup> The Bankruptcy Code defined transfer under section 101(41) to mean any transfer of interest.<sup>18</sup>

The various courts that have addressed this issue have disagreed on the appropriate outcome of this type of case,<sup>19</sup> the theory to support the outcome,<sup>20</sup> and the policy issues involved.<sup>21</sup> The majority of courts that have addressed this issue have concluded that a transfer, within the meaning of section

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by the Uniform Fraudulent Transfer Act. See UNIF. FRAUDULENT TRANSFER ACT, 7A U.L.A. 639 (1984). The later act retains the same basic structure as the 1918 Act. See *Id.* at 640.

15. Chandler Act, ch. 575 § 67(d)(2), 52 Stat. 840, 877 (1938) (codified at 11 U.S.C. § 107(d)(2) (1976) (repealed 1978)).

16. *Id.* Prior to the Chandler Act, the definition of a transfer under bankruptcy law did not include involuntary transfers. See Bankruptcy Act of July 1, 1898, ch. 541 § 1(25), 30 Stat. 544, 545 (amended 1938). The Chandler Act added involuntary transfer to the definition of transfer under the Act. See 11 U.S.C. § 1(30) (1976) (repealed 1978).

17. See 11 U.S.C. § 548(a)(2) (1982). Avoidance as a fraudulent conveyance requires essentially a four-pronged analysis. First, it must be determined that the debtor was *insolvent* at the time of the transfer. *Id.* § 548(a)(2)(B)(i). Second, it must be established that the disputed transfer occurred within *one year* of the filing of bankruptcy. *Id.* § 548(a). Third, there must be a *transfer* within the meaning of the Act. *Id.* Finally, the consideration received by the debtor must have been "less than a reasonably equivalent value." *Id.* § 548(a)(2)(A).

18. 11 U.S.C. § 101(41) (1982) (recodified at 11 U.S.C. § 101(48) (Supp. II 1984)).

19. One year after *Durrett*, the Fifth Circuit Court of Appeals affirmed that precedent in *Abramson*. In *Abramson*, however, Judge Clark wrote a strong dissent which acknowledged that the case was correctly decided under *Durrett*, but argued that *Durrett* was incorrectly decided. *Abramson*, 647 F.2d at 549 (Clark, J., dissenting) ("*Durrett* is simply wrong in its holding that a foreclosure sale is a transfer within the meaning of § 67(d)"); see also *Alsop*, 14 Bankr. at 986-87 (explicitly rejects *Durrett* and holds that no transfer occurs at foreclosure).

20. See *supra* note 7 and accompanying text.

21. See *Hulm*, 738 F.2d at 327 ("policy considerations cannot affect the outcome of his case, but must be addressed, if at all, by Congress"). This language is ironic in that the Congress had addressed the problem in the 1984 reform provisions. See *infra* notes 25-28 and accompanying text. It seems odd that the court did not refer to the legislative action in this regard. But see *Simpson*, *supra* note 32, at 82 (Simpson argues that no transfer occurs at foreclosure and that a contrary holding threatens the underpinnings of secured lending).

548, occurs at the foreclosure sale.<sup>22</sup> A few cases have held to the contrary that the transfer, in fact, occurs at the time that the underlying mortgage is perfected and that the foreclosure of the mortgage is just the mere consummation of the underlying transfer.<sup>23</sup> A third approach has begun to emerge. This approach acknowledges that a transfer occurs at the foreclosure sale, but holds that the price paid for the property should be deemed presumptively adequate.<sup>24</sup>

Finally, Congress stepped in and amended the pertinent provisions of the Bankruptcy Code in an apparent effort to clear up the conflict.<sup>25</sup> Presumably, the 1984 amendments mandate that a transfer occurs at foreclosure.<sup>26</sup> It would ap-

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22. *Hulm*, 738 F.2d at 325; *Abramson*, 647 F.2d at 549; *Durrett*, 621 F.2d at 204; *Hoffman v. Heritage Savings and Loan Ass'n (In re Garrison)*, 48 Bankr. 837, 839 (D. Colo. 1985); *Christian v. Ryan (In re Christian)*, 48 Bankr. 833, 835 (D. Colo. 1985); *Jacobson v. First State Bank of Benson (In re Jacobson)*, 48 Bankr. 497, 499 (Bankr. Minn. 1985); *White v. Luton (In re White)*, 47 Bankr. at 101 (Bankr. Tex. 1985); *Case Credit Corp. v. Kangas (In re Kangas)*, 46 Bankr. 102 (Bankr. Minn. 1985); *First Nat'l Mortgage Ass'n v. Wheeler (In re Wheeler)*, 34 Bankr. 818, 821 (Bankr. N.D. Ala. 1983); *Richardson v. Preston Family Invest. Co. (In re Richardson)*, 23 Bankr. at 446-47 (Bankr. Utah 1982); *Perdido Bay Country Club Estates, Inc. v. The Equitable Trust Co. (In re Perdido Bay Country Club Estates, Inc.)*, 23 Bankr. 36 (S.D. Fla. 1982).

23. See, e.g., *Alsop*, 14 Bankr. at 986-87; see also *Madrid*, 725 F.2d at 1199 (foreclosure sale is not a transfer under § 548(a)).

24. See *Madrid*, 21 Bankr. 424; *Reinboldt v. The Travelers Ins. Co. (In re Reinboldt)*, 39 Bankr. 678 (D. Minn. 1984) (this holding was implicitly overruled by *Hulm*, 738 F.2d at 327); see also *In re Upham*, 48 Bankr. 695 (Bankr. N.Y. 1985) ("The highest bid received in a properly conducted foreclosure action, where there has been no complaint of foul play or improper process, is the reasonably equivalent value of the property").

Much has been made in the scholarly writing of the distinction between judicial foreclosures and foreclosures created by "power of sale" clauses in contracts. Some have argued that only those foreclosures that are presided over by a court should be included in the rule that would presume the adequacy of the price paid. See *infra* note 55.

25. See 11 U.S.C. § 101(48) (Supp. II 1984). Section 101(48) amends section 101(41) to read that a transfer includes "every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with property or with an interest in property, including retention of title as a security interest and *foreclosure of the debtor's equity of redemption*." *Id.*

The 1984 amendment pertinent to fraudulent conveyance explicitly adds that an involuntary transfer may be a fraudulent conveyance. 11 U.S.C. § 548(a); see *infra* note 26.

26. See *Berman & Fierberg*, *supra* note 3, at 166. ("[t]he Amendments found in Section 101(48) of the Bankruptcy Amendments . . . ostensibly codified the *Durrett* line of cases on the issue of transfer . . ."). But see 130 CONG. REC. § 13771, § 13771-72 (daily ed. Oct. 5, 1984) (statements by Senators Dole and DeConcini) (disclaiming notion that the amendment codified *Durrett*). The comments of the Sen-

pear that Congress had accepted the *Durrett* position as correct concerning the transfer issue.<sup>27</sup> Subsequent "clarifications" to the 1984 amendments and recent scholarly debate, however, has cast doubt on whether the amendments do, in fact, dictate that a transfer occurs at the foreclosure sale.<sup>28</sup>

It was in light of the foregoing that the Eighth Circuit Court of Appeals decided *Hulm*.<sup>29</sup> The case arose before the 1984 amendments took effect and was therefore not governed by the most recent amendments to the provisions.<sup>30</sup>

In *Hulm*, the debtor granted a mortgage on a home he had purchased.<sup>31</sup> The debtor fell behind on his payments and eventually the mortgage was foreclosed.<sup>32</sup> The mortgagee instituted proceedings under state law which culminated in a judicial foreclosure sale.<sup>33</sup> The mortgagee purchased the property at the sale for about 70 percent of the appraised value.<sup>34</sup> After the statutory period of redemption expired, a sheriff's deed was issued to the mortgagee.<sup>35</sup> The debtor filed bankruptcy seventeen days later.<sup>36</sup>

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ators, however, have a minimizing effect on the clarification of the issue. See Berman & Fierberg, *supra* note 10, at 166. The authors of that article conclude that the 1984 amendments do not, in fact, solve the transfer problem. *Id.*

27. See 11 U.S.C. §§ 101(48), 548 (1982 & Supp. II 1984).

28. See *supra* note 26. The text of the Dole, DeConcini exchange reads:

Mr. DiConcini. "My understanding is that these provisions were not intended to have an effect one way or the other on the so-called *Durrett* issue."

Mr. Dole. "[N]o provision of the bankruptcy bill . . . was intended to intimate any view one way or the other regarding the correctness of the position taken in . . . the *Durrett* case. . . . Thus, the Amendment should not be construed to in any way codify *Durrett* or therein cast a cloud over non-collusive foreclosure sales."

130 CONG. REC. § 13771, § 13771-72 (daily ed. Oct. 5, 1985) (statements by Senators DeConcini and Dole).

29. 738 F.2d 323 (8th Cir.), *cert. denied*, 105 S. Ct. 398 (1984).

30. The amendment to section 548 became effective for any case filed after July 10, 1984. Pub. L. No. 98-353, § 552, formerly, § 553 (codified as note after 11 U.S.C. § 101 (Supp. II 1984)).

31. *Hulm*, 738 F.2d at 323.

32. *Id.* at 325.

33. *Id.*

34. *Id.* The price paid at the foreclosure sale represented an amount equal to the unpaid balance, accrued interest and statutory costs. *Id.* The property was eventually sold by First National in "as is" condition for approximately 30% more than it paid. Brief for Appellant/Cross-Appellee, *In re Hulm*, 738 F.2d 323 (8th Cir. 1984).

35. *Hulm*, 738 F.2d at 325.

36. *Id.* at 325. The deed was issued on July 9, 1982. First Federal, however, was unable to take possession until January 7, 1983, because of the automatic stay instituted at the time the debtor filed bankruptcy. *Id.*



The bankruptcy trustee argued that the foreclosure should be set aside as a fraudulent conveyance.<sup>37</sup> The bankruptcy court did not reach the issue of transfer, but merely held that absent fraud or collusion, the sale price at a regularly conducted judicial foreclosure sale should be deemed a reasonably equivalent value for the property.<sup>38</sup> In other words, the price paid at the judicial sale was presumed large enough to not de-

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37. *Hulm*, 738 F.2d at 325. The trustee also argued that the transaction should be set aside as a preferential transfer under section 547. Section 547 provides in pertinent part:

(b) Except as provided in subsection (c) of this section, the trustee may avoid any transfer of an interest of the debtor in property of the debtor

- (1) to or for the benefit of a creditor;
- (2) for or on account of an antecedent debt owed by the debtor before such transfer was made;
- (3) made while the debtor was insolvent;
- (4) made—
  - (A) on or within 90 days before the date of the filing of the petition;

(5) that enables such creditor to receive more than such creditor would receive if—

- (A) the case were a case under chapter 7 of this title;
- (B) the transfer had not been made; and
- (C) such creditor received payment of such debt to the extent provided by the provisions of this title.

(f) For the purposes of this section, the debtor is presumed to have been insolvent on and during the 90 days immediately preceding the date of the filing of the petition.

11 U.S.C. § 547 (1982 & Supp. II 1984). For a complete discussion of the issue of preferential transfers, see generally L. KING, 4 COLLIER ON BANKRUPTCY ¶ 547.01-.55 (15th ed. 1985) [hereinafter cited as COLLIER ON BANKRUPTCY].

The Eighth Circuit court briefly addressed the preference section in two cases during the survey period. First, in *Brown v. First Nat'l Bank of Little Rock, Ark.*, 748 F.2d 490 (8th Cir. 1984), the court held that funds paid to the creditor for the purpose of satisfying the debtor corporation's promissory note could not be recovered as a preferential transfer since the note was paid out of the personal funds of the comakers of the note, and the comakers did not receive any property from the debtor in return for the payment. *Id.* at 491. The court noted that one of the elements of a preferential transfer is that the transferred property must be property of the bankrupt's estate and that the burden of proof is on the trustee to prove each element of preferential transfer. *Id.*

Secondly, in *Carlson v. Farmers Home Admin. (In re Newcomb)*, 744 F.2d 621 (8th Cir. 1984), the court held that money placed in escrow more than 90 days prior to filing bankruptcy could not be avoided as a preferential transfer because the transfer of funds was deemed "perfected" as of the time it was placed in escrow, notwithstanding the fact that the transfer was contingent. *Id.* at 627; accord *Cate v. Nicely (In re Knox Kreations, Inc.)*, 656 F.2d 230, 231 (6th Cir. 1981) (payment from escrow account not avoidable as a preferential transfer because transfer occurred at time escrow created).

38. *Hulm*, 738 F.2d at 325. The bankruptcy court rejected both claims and the trustee did not appeal the preferential transfer portion of the decision. *Id.*

fraud the estate of funds. Since no fraud was shown, the bankruptcy court refused to set aside the sale as a fraudulent conveyance.<sup>39</sup>

The district court held that a transfer occurs at the foreclosure sale and that there was no presumption of adequate consideration.<sup>40</sup> The court concluded that the price paid in this case was, in fact, reasonably equivalent.<sup>41</sup> On appeal, the Eighth Circuit held that the foreclosure of a mortgage effected a transfer of interest within the meaning of section 548.<sup>42</sup> Secondly, the court explicitly rejected the bankruptcy court's ruling that, absent fraud or collusion, the sale price obtained at a judicial foreclosure sale is a reasonably equivalent value of the property as a matter of law.<sup>43</sup> Since the district court held the price in this case to be equivalent without the aid of any sort of evidence, the Eighth Circuit vacated the judgment and remanded the case to the bankruptcy court for a determination of the reasonableness of the value given.<sup>44</sup>

The issue of whether the court was correct in deciding that a foreclosure is a transfer under the Act that can be avoided under section 548 has been extensively debated elsewhere,<sup>45</sup> but it is probably moot because of the 1984 amendments to the Code.<sup>46</sup> The *Hulm* court was unconcerned about the policy problems associated with its decision.<sup>47</sup> It seems as though the courts will, for better or worse, consider foreclosure a transfer

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39. *Id.* The bankruptcy court did not specifically reach the issue of whether a transfer occurs at the foreclosure sale. The court merely said that whatever transfer there might have been was irrelevant because the price paid was adequate as a matter of law. *Id.*

40. *Id.* at 324.

41. *Id.* at 326. The district court held that the price paid in this case was reasonably equivalent. The court, however, conducted no evidentiary hearing in that regard. *See id.*

42. *Id.* at 327. The court noted that even after the mortgage had been perfected, the debtor retained an interest in the property at least until the end of the statutory redemption period. *Id.* at 326. The court said that under North Dakota law, the debtor's interest in the property was not terminated until the issuance of the sheriff's deed. *Id.*; see N.D. CENT. CODE § 32-19-09 (1978).

43. *Hulm*, 738 F.2d at 327. The bankruptcy court relied on *In re Madrid*, 21 Bankr. 424 (Bankr. 9th Cir. 1982), in formulating its rule.

44. *Hulm*, 738 F.2d at 327. The court directed the bankruptcy court to determine whether the amount paid was a reasonably equivalent value for the property. *Id.*

45. See Comment, *Mortgage Foreclosure as Fraudulent Conveyance: Is Judicial Foreclosure An Answer to the Durrett Problem*, 1984 WIS. L. REV. 195, 228-34 (1984).

46. See *supra* notes 25-28 and accompanying text.

47. *Hulm*, 738 F.2d at 327; see also *supra* note 21.

within the meaning of the Bankruptcy Code.<sup>48</sup> This is particularly true in light of the 1984 amendments.<sup>49</sup>

A simple and logical solution to this problem is for the bankruptcy court to deem the sale price received at a regularly conducted judicial foreclosure sale adequate as a matter of law,<sup>50</sup> thereby removing the uncertainty created by subjecting these transactions to avoidance under section 548. This solution would equitably balance the competing policy considerations involved, and would be less disruptive to real estate transactions.<sup>51</sup>

The basic policies of the Bankruptcy Code are to rehabilitate the bankrupt,<sup>52</sup> and to promote equality among creditors of the estate by assuring orderly distribution of the estate to those creditors.<sup>53</sup> Section 548 helps foster these policies by assuring that the creditors will receive a fair chance to receive as much payment as possible. The theory extends to judicial foreclosure sales which occur within one year of bankruptcy, so the advocates contend, because the creditors need to be protected from underpayment at the judicial sale.<sup>54</sup>

Judicial foreclosure<sup>55</sup> sales are conducted in accordance with

48. See *supra* notes 19-28 and accompanying text.

49. But see *supra* note 28 (statements by DiConcini and Dole).

50. See *Madrid*, 21 Bankr. at 426; Comment, *supra* note 45, at 233-34; see also *Abrahamson*, 647 F.2d at 549-50 (Clark, J., dissenting). But see *Hulm*, 738 F.2d at 327.

51. See Comment, *supra* note 45, at 205-08.

52. See *id.* at 214 & n.117.

53. See H.R. REP. NO. 95th Cong., 2d Sess. 177-78, reprinted in 197 U.S. CODE CONG. AD. NEWS 5963, 6138. See also Note, *The New Bankruptcy Act: A Revision of Section 67d—The Death of a Dilemma*, 7 HOFSTRA L.R. 537, 537 (1979).

54. See *Hulm*, 738 F.2d 323. But see Comment, *supra* note 45, at 214 (author argues that the protections inherent in judicial foreclosure should be enough to protect creditors).

55. Judicial foreclosure is by far the most widely used foreclosure procedure used in the United States. See G. OSBORNE, G. NELSON & D. WHITMAN, REAL ESTATE FINANCE LAW § 7.11, at 466 (1979). The other basic type of foreclosure mechanism available in the United States is a nonjudicial or "power of sale" clause in the loan agreement. *Id.* § 7.9, at 442. For an excellent discussion of the types of foreclosure proceedings, their differences, and how those differences relate to the doctrine of fraudulent conveyance, see Comment, *supra* note 45, at 228-35.

Some have argued that only those foreclosures that are presided over by the court should be afforded the presumption of reasonably equivalent value. *Id.* at 203-08. But see *Berman & Fierberg*, *supra* note 10 at 166. "It appears that there does not exist at least within the reported cases, any distinction between the two forms of foreclosure sale." *Id.*; contra *Simpson*, *Real Property Foreclosures: The Fallacy of Durrett*, 18 Real Prop. Prob & Tr. J. 73 (1983). *Simpson* argues that since the foreclosure does not constitute a transfer that in no event should it be disallowed in bankruptcy.

certain procedures and safeguards.<sup>56</sup> The purposes of foreclosures are basically to protect the secured creditor who has the primary interest in the subject property. Another purpose involved is to promote certainty in the financial dealings of the parties.<sup>57</sup> In judicial foreclosure, a court has continuing jurisdiction over the proceeding in order to ensure fairness.<sup>58</sup> The court's power includes the discretion to either approve or disapprove the sale.<sup>59</sup> If the price paid is so inadequate as to be unfair, the court may, in its discretion, disallow it.<sup>60</sup>

In cases like *Hulm*, where the foreclosure sale is presided over by a court of general jurisdiction, the price paid for the property should not be open to attack by the bankruptcy trustee.<sup>61</sup> Considerations of policy and economics should be taken into account. An effort should be made to harmonize the law of bankruptcy with foreclosure law and the relevant policies of each should be given effect.<sup>62</sup> The bankruptcy court and a court presiding over a foreclosure sale should not be

56. See generally R. KRATOVIL & R. WERNER, *MODERN MORTGAGE LAW AND PRACTICE* § 41.09 (a)-(q)(2), at 611-23 (2d ed. 1981) (discussing general aspects of judicial foreclosure).

57. See Note, *supra* note 12, at 278 (discusses the uncertainty created by *Durrett*).

58. See Comment, *supra* note 45, at 203-08.

59. *Id.* The court may withhold confirmation of a foreclosure sale if it can be established that fraud or mistake was involved in the sale. See Washburn, *The Judicial and Legislative Response to Price Inadequacy in Mortgage Foreclosure Sales*, 53 S. CAL. L. REV. 843, 862-63 (1980). Similarly, confirmation may be denied if the price is shocking to the conscience of the court. *Id.* at 862. Thus, a court has authority to deny confirmation to unconscionable sales.

60. See Comment, *supra* note 45, at 209.

61. Much has been made of the distinction between judicial and nonjudicial foreclosure proceedings as they relate to avoidance. See Comment, *supra* note 45. The writer of the Comment argues that a nonjudicial foreclosure sale should not be presumed to provide adequate compensation because of the lack of judicial supervision. *Id.* at 232-33.

62. See *Madrid*, 21 Bankr. 424; see also Simpson, *supra* note 55, at 77-78.

[A] well-established, and obviously forgotten, principle of bankruptcy law—namely, the avoidance provisions of bankruptcy law have never been intended to invalidate, and have never even pertained to, the pre-petition enforcement of a lien valid under nonbankruptcy law and otherwise unavoidable in bankruptcy. (footnote omitted)(emphasis in original).

Coppel & Kann, *supra* note 5, at 677.

[T]he Bankruptcy Code defines "transfer" broadly to include "every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with property or with an interest in property, including retention of title as a security interest. . . . Under this formulation a foreclosure sale clearly constitutes a transfer because it effects a transfer of possession . . . (footnotes omitted)(emphasis in original).

Alden, Gross & Borowitz, *supra* note 12, at 1608.

fundamentally at odds. Permitting bankruptcy courts to disaffirm foreclosure sales thwarts the policy of protecting the foreclosing creditor and also decreases certainty in transactions.<sup>63</sup> By allowing the bankruptcy court to overturn foreclosure sales casts a cloud on the title of property purchased at foreclosure for a year following the sale.<sup>64</sup> The inevitable effect of this will be to further depress the prices received at foreclosure sales.<sup>65</sup> Ultimately, this will cast a cloud over all secured transactions because creditors will be uncertain about their ability to collect on a delinquent mortgage.<sup>66</sup>

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63. See Comment, *supra* note 45, at 232 (extending *Durrett* would cause the primary advantage of judicial foreclosure—stability and marketability of title—to be lost). *Id.*

64. In effect, the title can be clouded for well over the one year provided in section 548. The transfer has been held to occur on the date of the sale and not at the expiration of the redemption period. See, e.g., *In re Kangas*, 46 Bankr. 102. Therefore, the redemption and fraudulent conveyance time periods run concurrently. This, however, ignores the fact that the complaint filed by the trustee to set aside the sale may be filed up to two years after the trustee is appointed. 11 U.S.C. § 546(a) (1982). Furthermore, the trustee will not be elected until sometime after the petition is filed. See 11 U.S.C. § 702 (1982 & Supp. II 1984). Therefore, the period of risk to purchasers can be much longer than one year. See, e.g., Note, *supra* note 12, at 278 n.120.

For example, in a state like North Dakota where the redemption period is one year (six months under subsection one of § 32-19.1-04), the additional risk to creditors is clear. Under the Eighth Circuit's interpretation of section 548, the purchased property is at risk for a longer period than it would have been just under the redemption statute. See N.D. CENT. CODE § 28-24-02 (Supp. 1985).

In a state where the statutory redemption period is one year, the argument could be made that the risk to the buyer is not increased because the time periods of risk coincide. See, e.g., MINN. STAT. § 580.23, subd. 2 (1984) (one year redemption on mortgages executed before July 1, 1967; mortgages where less than two-thirds of the principle amount is owed; and for parcels of land over 10 acres). This argument, however, ignores the nature of statutory redemption. Redemption is a known and quantifiable risk taken into account by purchasers at foreclosure. In the event the debtor is able to raise the necessary funds the property reverts automatically. Section 548, on the other hand, affords no simple procedures to determine the appropriateness of the price paid, and therefore, recovery of the property is uncertain.

Forcing the purchaser to be at risk under section 548 of the Bankruptcy Code essentially forces the creditor to risk buying a lawsuit in an effort to maintain ownership of the property. Should the trustee determine that the price paid at foreclosure is inadequate within the meaning of section 548, the purchaser will be forced into court to attempt to protect the investment. This situation, while not necessarily increasing the time period of risk, definitely increases the number of risks the purchaser is subject to and decreases the certainty of the transactions.

65. See Simpson, *supra* note 55, at 75.

66. See Madrid, 757 F.2d at 1202 (discusses negative repercussions of allowing a "de facto right of redemption" under the Code); see also Note, *supra* note 12, at 278-79. At present, a mortgagee who completes a foreclosure sale cannot be certain whether it accomplished its objective by recovering its investment or whether, at

If the price received at a judicial foreclosure sale were presumed adequate as a matter of law, this problem could be avoided.<sup>67</sup> This rule would provide an adequate balance between the interests of the bankruptcy court in promoting equality and the interests of secured creditors who want to rely on the title of property obtained at foreclosure sale.

In addition to effectively balancing interests, this rule is also grounded in sound logic. Since the foreclosure sale is presided over by a judge, who has the power to disallow the sale if the price is truly inadequate, it is logical to assume that, as a matter of law, the sale price was adequate.<sup>68</sup> Similarly, by not presuming adequacy of consideration, prices obtained at foreclosure are further depressed.<sup>69</sup> With further depressed prices, the problems associated with avoiding a sale on the grounds that the conveyance was fraudulent would be aggravated. Such findings would further increase the likelihood of sales being disallowed, which would further depress prices.<sup>70</sup> The bankruptcy court's interest in preserving the estate value would also be served under this rule as it would promote higher prices at foreclosure sales. Higher prices would increase the value of the estate, which, in turn, would decrease the likelihood of inadequacy of the purchase price. A further policy supporting this rule is that it would also advance the secured creditors' preferred position under the Bankruptcy Code by fulfilling the creditor's justified reliance on the pledge property when making loans.<sup>71</sup>

In conclusion, it would seem that the Eighth Circuit in *Hulm* was correct in holding that a transfer of the debtor's interest occurs at the foreclosure sale.<sup>72</sup> The Eighth Circuit, however, rejected the argument that the price paid at the sale is presumed to be adequate. The decision, although consistent with a majority of jurisdictions, is unfortunate. It promotes uncertainty of title and promotes conflict between the bankruptcy

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some future time, a bankruptcy court will avoid the sale. Comment, *supra* note 45, at 235.

67. Comment, *supra* note 45, at 235.

68. See Berman & Fierberg, *supra* note 3, at 167; see also Comment, *supra* note 45, at 219 (discusses circumstances in which judge can disallow sale).

69. *Id.*; see also Simpson, *supra* note 55, at 80-81.

70. See Simpson, *supra* note 32, at 80.

71. See Comment, *supra* note 45, at 233.

72. But see *supra* notes 26-28 and accompanying text.

courts and state courts in determining the adequacy of price at foreclosure sales.<sup>73</sup>

## II. DISCHARGEABILITY

The Eighth Circuit has interpreted the Bankruptcy Code's provisions concerning discharge of debts<sup>74</sup> in two recent cases. In the cases of *In re Hunter*,<sup>75</sup> and *In re Long*,<sup>76</sup> the court reaffirmed the policy that exceptions to discharge should be narrowly construed.<sup>77</sup> In *Hunter*, the court held that, where an underlying debt has both dischargeable and nondischargeable components, foreclosure proceeds should be apportioned between the dischargeable and nondischargeable components.<sup>78</sup> In *Long*, the court held that where a certain sum of money had been wrongfully converted for the debtor's use, the debt was still dischargeable because the debtor lacked subjective intent to defraud.<sup>79</sup>

### A. Background of Section 523

One of the general purposes of the Bankruptcy Code is to give the debtor a "fresh start" by excusing legal obligations.<sup>80</sup> Certain exceptions, however, have been recognized and codified under bankruptcy law.<sup>81</sup> The current Bankruptcy Code exempts from discharge ten different classes of obligations.<sup>82</sup> Section 523 of the Code also provides a mechanism for a credi-

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73. See Comment, *supra* note 45, at 233-34.

74. 11 U.S.C. § 523 (1982 & Supp. II 1984).

75. 771 F.2d at 1130.

76. 774 F.2d at 879.

77. Because of the strong public policy in favor of allowing the debtor a fresh start through the use of bankruptcy proceedings, the courts have traditionally held that all debts should be discharged unless they fall within certain narrowly defined categories. See, e.g., *Hunter*, 771 F.2d at 1128; see also *infra* notes 103-04 and accompanying text.

78. 771 F.2d at 1130. See *infra* text accompanying notes 91-100.

79. 774 F.2d at 881-82. See *infra* text accompanying notes 103-134.

80. *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934); accord *Perez v. Campbell*, 402 U.S. 637, 648 (1971).

81. 11 U.S.C. § 523. Several kinds of debts are exempted from discharge under the statute. The doctrine of dischargeability has developed through a series of evolutionary steps. 3 COLLIER ON BANKRUPTCY, *supra* note 37, ¶ 523.01. The kinds of debts exempt from discharge have increased throughout the history of bankruptcy law in the United States. See *id.*

82. These classes of debts are those that are deemed inappropriate to discharge for public policy reasons. Debts that are not dischargeable include:

(1). . . a tax or a customs duty—

(A) of the kind and for the periods specified in section 507(a)(2) or 507(a)(6) of this title, whether or not a claim for such tax was filed or allowed;

(B) with respect to which a return, if required—

(i) was not filed; or

(ii) was filed after the date on which such return was last due, under applicable law or under any extension, and after two years before the date of the filing of the petition; or

(C) with respect to which the debtor made a fraudulent return or willfully attempted in any manner to evade or defeat such tax;

11 U.S.C. § 523(a)(1) (1982 & Supp. II 1984). *See, e.g.,* *Bruning v. United States*, 376 U.S. 358 (1964).

Section 523(a)(2) specifically provides:

(2) for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by—

(A) false pretenses, a false representation, or actual fraud, other than a statement respecting the debtor's or an insider's financial condition;

(B) use of a statement in writing—

(i) that is materially false;

(ii) respecting the debtor's or an insider's financial condition;

(iii) on which the creditor to whom the debtor is liable for such money, property, services, or credit reasonably relied; and

(iv) that the debtor caused to be made or published with intent to deceive; or

(C) for purposes of subparagraph (A) of this paragraph, consumer debts owed to a single creditor and aggregating more than \$500 for "luxury goods or services" incurred by an individual debtor on or within forty days before the order for relief under this title, or cash advances aggregating more than \$1,000 that are extensions of consumer credit under an open end credit plan obtained by an individual debtor on or within twenty days before the order for relief under this title, are presumed to be nondischargeable; "luxury good or services" do not include goods or services reasonably acquired for the support or maintenance of the debtor or a dependent of the debtor; an extension of consumer credit under an open end credit plan is to be defined for purposes of this subparagraph as it is defined in the Consumer Credit Protection Act (15 U.S.C. 1601 et seq.).

11 U.S.C. § 523(a)(2) (1982 & Supp. II 1984). *See Hunter*, 771 F.2d 1126; *see also Tappan Co. v. Klusman (In re Klusman)*, 29 Bankr. 865 (Bankr. S.D. Ohio 1983) (fraud exception must be strictly construed in favor of the debtor).

Section 523(a)(3) specifically provides:

(3) [debts] neither listed nor scheduled under section 521(1) of this title, with the name, if known to the debtor, of the creditor to whom such debt is owed, in time to permit—

(A) if such debt is not of a kind specified in paragraph (2), (4), or (6) of this subsection, timely filing of a proof of claim, unless such creditor had notice or actual knowledge of the case in time for such timely filing; or

(B) if such debt is of a kind specified in paragraph (2), (4), or (6) of this subsection, timely filing of a proof of claim and timely request for a determination of dischargeability of such debt under one of such paragraphs, unless such creditor had notice or actual knowledge of the case in the time for such timely filing and request;

11 U.S.C. § 523(a)(3) (1982).

Section 523(a)(4)-(5) provides:

(4) for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny;



(5) to a spouse, former spouse, or child of the debtor, for alimony to, maintenance for, or support of such spouse or child, in connection with a separation agreement, divorce decree, or other order of a court of record or property settlement agreement, but not to the extent that—

(A) such debt is assigned to another entity, voluntarily, by operation of law, or otherwise (other than debts assigned pursuant to section 402(a)(26) of the Social Security Act, or any such debt which has been assigned to the Federal Government or to a State or any political subdivision of such State); or

(B) such debt includes a liability designated as alimony, maintenance, or support, unless such liability is actually in the nature of alimony, maintenance, or support;

11 U.S.C. § 523(a)(4)-(5) (1982 & Supp. II 1984). See generally Hoffman & Murray, *Obligations that Cannot be Erased*, 5 FAM. ADVOC. No. 3, 18 (1983); Note, *Discharge of Post-Marital Support Obligations Under the New Bankruptcy Code*, 4 HARV. WOMEN'S L.J. 177 (1981).

Section 523(a)(6) requires: "willful and malicious injury by the debtor to another entity or to the property of another entity." 11 U.S.C. § 523(a)(6) (1982). Unlike its predecessor, (11 U.S.C. § 35(a)(6) (1976) (repealed 1978)) this provision does not expressly include willful and malicious *conversion* of property. The courts, however, have held that the provision still applies to situations where the debtor has misappropriated property for his own use. See *First Nat'l Bank of Red Bud v. Kimzey (In re Kimzey)*, 761 F.2d 421, 424 (7th Cir. 1985); *Thorp Credit & Thrift Co. v. Pommerer (In re Pommerer)*, 10 Bankr. 935, 940 (Bankr. D. Minn. 1981). See also *Long*, 774 F.2d at 882; *Webster City Prod. Credit Ass'n v. Simpson (In re Simpson)*, 29 Bankr. 202, 208 (Bankr. N.D. Iowa 1983); *Everwed Co. v. Ayers (In re Ayers)*, 25 Bankr. 762, 775-76 (Bankr. Tenn. 1982); *Borg-Warner Acceptance Corp. v. Simmons (In re Simmons)*, 9 Bankr. 62, 66 (Bankr. S.D. Fla. 1981); *Grand Piano & Furniture Co. v. Hodges (In re Hodges)*, 4 Bankr. 513, 514-15 (Bankr. Va. 1980).

Section 523(a)(7)-(8) provides:

(7) to the extent such debt is for a fine, penalty, or forfeiture payable to and for the benefit of a governmental unit, and is not compensation for actual pecuniary loss, other than a tax penalty—

(A) relating to a tax of a kind not specified in paragraph (1) of this subsection; or

(B) imposed with respect to a transaction or event that occurred before three years before the date of the filing of the petition;

(8) for an educational loan made, insured, or guaranteed by a governmental unit, or made under any program funded in whole or in part by a governmental unit or a nonprofit institution, unless—

(A) such loan first became due before five years (exclusive of any applicable suspension of the repayment period) before the date of the filing of the petition; or

(B) excepting such debt from discharge under this paragraph will impose an undue hardship on the debtor and the debtor's dependents;

11 U.S.C. § 523(a)(7)-(8) (1982 & Supp. II 1984). See generally Ayres & Sagner, *The Bankruptcy Reform Act and Student Loans: Unravelling New Knots*, 9 J. COLLEGE & U.L. REV. 361 (1983); Kalevitch, *Educational Loans in Bankruptcy*, 2 N. ILL. U.L. REV. 325 (1982); Ahart, *Discharging Student Loans in Bankruptcy*, 52 AM. BANKR. L.J. 201 (1978).

Section 523(a)(9) provides:

(9) that was or could have been listed or scheduled by the debtor in a prior case concerning the debtor under this title . . . . 11 U.S.C. § 523(a)(9) (1982 & Supp. II 1984).

[10](9) to any entity, to the extent that such debt arises from a judgment or consent decree entered in a court of record against the debtor wherein liability was incurred by such debtor as a result of the debtor's operation of

tor to challenge the dischargeability of debts.<sup>83</sup> The provisions of section 523, however, apply only to individual debtors and do not apply to commercial debtors.<sup>84</sup>

These exceptions represent situations where the legislature has determined that dischargeability of the debts would be contrary to public policy.<sup>85</sup> The cases have uniformly held, however, that the policy of allowing the debtor a fresh start is overriding, and that exceptions to dischargeability are to be strictly construed in order to facilitate that policy.<sup>86</sup> The over-

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a motor vehicle while legally intoxicated under the laws or regulations of any jurisdiction within the United States or its territories wherein such motor vehicle was operated and within which such liability was incurred; or

11 U.S.C. § 523(a)(9) (Supp. II 1984).

When Congress added the new section 9 concerning the nondischargeability of debts arising from drunken driving, it neglected to renumber the old section 9 as section 10. Presumably, Congress will rectify this error. See 3 COLLIER ON BANKRUPTCY, *supra* note 37, ¶ 523.18A n.2.

83. Section 523(b)-(d) of the Bankruptcy Code provides:

(b) Notwithstanding subsection (a) of this section, a debt that was excepted from discharge in a prior case concerning the debtor under this title, or under the Bankruptcy Act, is dischargeable in a case under this title unless, by the terms of subsection (a) of this section, such debt is not dischargeable in the case under this title.

(c) Except as provided in subsection (a)(3)(B) of this section, the debtor shall be discharged from a debt of a kind specified in paragraph (2), (4), or (6) of subsection (a) of this section, unless, on request of the creditor to whom such debt is owed, and after notice and a hearing, the court determines such debt to be excepted from discharge under paragraph (2), (4), or (6), as the case may be, of subsection (a) of this section.

(d) If a creditor requests a determination of dischargeability of a consumer debt under subsection (a)(2) of this section, and such debt is discharged, the court shall grant judgment in favor of the debtor for the costs of, and a reasonable attorney's fee for, the proceeding if the court finds that the position of the creditor was not substantially justified, except that the court shall not award such costs and fees if special circumstances would make the award unjust.

11 U.S.C. § 523(b)-(d) (1982 & Supp. II 1984). Cf. *F & M Marquette Nat'l Bank v. Richards*, 780 F.2d 24 (8th Cir. 1985). In this case, the issue decided by the court was whether the conversion of a bankruptcy case from Chapter 11 reorganization to Chapter 7 liquidation provides creditors with a new 60 day period with which to file claims to determine the dischargeability of debts. The court held that conversion does afford an additional period to file claims. *Id.* at 25. Since a conversion from Chapter 11 to Chapter 7 constitutes a new order for relief under section 348(a), the court reasoned a new period was justified. *Id.* at 26. The court also noted that to deny an additional period might cause a hardship for creditors since under Chapter 11 proceedings, creditors are much less likely to challenge the dischargeability of the debt. *Id.*

84. 11 U.S.C. § 523(a) (1982). See, e.g., *Yamaha Motor Corp. U.S.A. v. Shadco, Inc.*, 762 F.2d 668 (8th Cir. 1985).

85. But see *supra* note 82 and accompanying text.

86. *Quadra, Ltd. v. Konchan (In re Konchan)*, 36 Bankr. 393, 396 (Bankr. N.D. Ill. 1984); *Finance One of Fla., Inc. v. Scarbaci (In re Scarbaci)*, 34 Bankr. 344, 345

riding concern is that an honest debtor should be exonerated by the bankruptcy proceeding.<sup>87</sup> Conversely, the dischargeability exceptions are intended to ensure that the relief intended for honest debtors not be extended to dishonest debtors.<sup>88</sup>

The two recent Eighth Circuit cases address portions of the dischargeability provision.<sup>89</sup> The cases demonstrate that the court is willing to go to great lengths in protecting the debtor.<sup>90</sup>

### B. *In re Hunter*

During the eighteen months of the survey period, the Eighth Circuit Court of Appeals first addressed the issue of dischargeability in *In re Hunter*.<sup>91</sup> The case specifically dealt with how a prebankruptcy payment should be allocated to an underlying debt.<sup>92</sup> One portion of the debt was deemed nondis-

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(Bankr. S.D. Fla. 1983); *Chrysler Credit Corp. v. Freeman (In re Freeman)*, 30 Bankr. 704 (Bankr. La. 1983); *Heinold Commodities & Securities, Inc. v. Hunt (In re Hunt)*, 30 Bankr. 425, 436 (M.D. Tenn. 1983); *Lake County Dep't of Pub. Welfare v. Marino (In re Marino)*, 29 Bankr. 797, 799 (N.D. Ind. 1983).

87. See, e.g., *Bostwick v. United States*, 521 F.2d 741 (8th Cir. 1975) (purpose of Bankruptcy Act is to allow debtor to lead productive economic life).

88. See *Castner Knott Co. v. Wilson (In re Wilson)*, 12 Bankr. 363, 370 (Bankr. M.D. Tenn. 1981) (fraud exception to discharge designed to discourage fraud and ensure that dishonest debtors not be protected by the Act).

89. *Hunter*, 771 F.2d at 1130 (when debt is incurred by fraud, debtor not entitled to relief under the Act). *Long*, 774 F.2d at 882 (unless debtor acts with malice, discharge will not be precluded). See 11 U.S.C. § 523(a)(2), (6).

90. For instance, in *Hunter*, the court adopted an equitable approach in an effort to strike a balance between the debtor-favoring policy and the justifiable expectations of the creditor. *Hunter*, 771 F.2d at 1130.

In *Long*, the court seems to blur the distinction between protecting an honest debtor and allowing the debtor free reign to misappropriate funds. Specifically, the standard enunciated in *Long* appears to allow the conversion of property for the debtor's own use, so long as the debtor's motives are pure. See *Long*, 774 F.2d at 880-81.

91. 771 F.2d 1126 (8th Cir. 1985).

92. *Id.* The court ruled that the bankruptcy court's determination that there was no fraudulent misrepresentation on the part of the debtor was not clearly erroneous. *Id.* at 1129. The court also addressed issues concerning an obligation by the debtor to pay attorneys' fees and interest on the debts. The court held that the status of the debt created by the agreement to pay attorneys' fees depends on the dischargeability of the primary debt. *Id.* at 1131. See *Primm v. Foster (In re Foster)*, 38 Bankr. 639, 641-42 (Bankr. M.D. Tenn. 1984); *Chambers v. Chambers (In re Chambers)*, 36 Bankr. 42, 45-46 (Bankr. W.D. Wisc. 1984); *Cooley v. Sposa (In re Sposa)*, 31 Bankr. 307, 310 (Bankr. E.D. Va. 1983). The *Hunter* court held that if the attorneys' fees agreement was ancillary to the nondischargeable portion of the debt then the creditor would be entitled to recover them as they would be nondischargeable. *Hunter*,

chargeable by the bankruptcy court while another was discharged.<sup>93</sup>

The district court affirmed the findings of fact on dischargeability but disagreed on allocation of the payment to the debt.<sup>94</sup> The district court concluded that since the two debts had been consolidated into a single, indivisible note, the proceeds should be allocated between the two parts according to their proportion of the whole.<sup>95</sup>

On appeal, the Eighth Circuit affirmed the district court in all respects.<sup>96</sup> In this case of first impression, the court fashioned a remedy that it determined was fair to all parties.<sup>97</sup> The court found that the underlying debt constituted a single bal-

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771 F.2d at 1131-32. The court remanded the case to the bankruptcy court to determine whether all or part of the attorneys' fees and interest should be awarded as part of the nondischargeable debt. *Id.* at 1132.

93. The total debt of \$27,000 was comprised of a \$15,000 nondischarged portion and a \$12,000 discharged portion. *Id.* at 1128. The facts of the case show that the debtor was a real estate broker engaged in speculative ventures. He called the creditor and stated that he was trying to raise \$30,000 to purchase some property. *Id.* at 1127. The debtor was attempting to purchase an entire block in Orlando, Florida, for \$300,000 - \$500,000. The debtor indicated that for \$15,000 the creditor would become an equal partner in the venture. In fact, the \$15,000 represented only an investment in a small portion of the property. The full scope of the deal was never explained to the creditor. *Id.* The creditor sent the \$15,000, but when the deal eventually fell through, the debtor retained the money. *Id.* Later, the creditor, who was the debtor's uncle by marriage, loaned the debtor an additional \$12,000 to pay taxes on other property. *Id.* When no payments were made, the creditor demanded his money. *Id.* at 1127-28. The debtor gave a \$27,000 mortgage on his house to satisfy the entire debt. *Id.* at 1128. The mortgage was subsequently foreclosed, netting slightly over \$12,000. The debtor reaffirmed the remaining debt of about \$15,000 and agreed to pay the creditor's attorney's fees and interest. The debtor then filed bankruptcy and the creditor instituted action to determine the dischargeability of the debts. *Id.* The bankruptcy court found the \$15,000 debt to be nondischargeable because it was obtained by fraud. *Jennen v. Hunter (In re Hunter)* 36 Bankr. 28, 31 (Bankr. Minn. 1983). The bankruptcy court, however, found the \$12,000 loan dischargeable because the creditor had not relied on any misrepresentation of the debtor. *Id.* The bankruptcy court held that the partial payment of \$12,000 obtained at the foreclosure should be subtracted from the nondischarged debt because that was the first debt incurred. *Id.* at 32. The bankruptcy court justified its decision by applying the "first in first out" principle. *See Hunter*, 771 F.2d at 1129. Since Congress mandates narrow construction of nondischargeability, the bankruptcy court determined this to be a fair result. 36 Bankr. at 32.

94. *Jennen v. Hunter (In re Hunter)*, 52 Bankr. 912, 915-16 (D. Minn. 1984).

95. *Id.* at 916. It is interesting to note that the two lower courts involved in this case cite no authority upon which to base their decisions. *See Hunter*, 52 Bankr. at 915-16; *Hunter*, 36 Bankr. at 31-32.

96. Employing the clearly erroneous standard, the Eighth Circuit refused to disturb the findings on dischargeability. *Hunter*, 771 F.2d at 1129.

97. *See id.* at 1130; *cf. Stevenson v. Stevenson Assoc., Inc. (In re Stevenson Assoc.,*

ance even though incurred separately.<sup>98</sup> The debts were treated differently only because of "the provisions of the Bankruptcy Code which makes some debts nondischargeable and others dischargeable."<sup>99</sup> The court found that apportionment would balance the relevant policy objectives by fully compensating the creditor for the fraudulent debt while releasing the debtor from the nonfraudulent debt.<sup>100</sup>

Under the authority cited by the Eighth Circuit, this case was correctly decided. Since the court refused to overturn the factual determinations made by the bankruptcy court, it had to protect the debtor in relation to the discharged debt.<sup>101</sup> Similarly, applying the proceeds only to the nondischarged debts would have contravened the clear language of section 523(a)(6).<sup>102</sup>

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Inc.), 777 F.2d 415, 419 (8th Cir. 1985) (bankruptcy court possesses equitable powers).

The Eighth Circuit recognized three possible approaches to solving the apportionment problem. The first approach was the "first in first out" approach used by the bankruptcy court. *Hunter*, 771 F.2d at 1129-30. The debtor advocated this approach as it would have allowed him to escape most of the nondischarged debt. *Id.*; see *Hunter* 36 Bankr. at 32. The Eighth Circuit rejected this approach because only honest debtors are entitled to protection under the Code. *Hunter*, 771 F.2d at 1130. The court said, "when dishonesty is demonstrated with respect to a specific debt, the debtor 'is no longer entitled to the benefit of debtor rehabilitation policy considerations.'" *Id.* (quoting *In re Wilson*, 12 Bankr. 363, 370 (Bankr. M.D. Tenn. 1981)).

The second possibility rejected by the court called for total application of the proceeds to the discharged debt. *Id.* at 1130. This approach was advocated by the creditor as it would have resulted in maximum return. The court said this approach was punitive in nature and therefore contravened the Code protections intended for honest debtors. *Id.*

The final approach was to apportion the debt between the dischargeable and nondischargeable portions. *Id.* The court felt this best balanced the relevant interests and was the "remedy best suited to the harm." *Id.* (quoting *Garnatz v. Stifel, Nicolaus & Co.*, 559 F.2d 1357, 1360 (8th Cir. 1977), *cert. denied*, 435 U.S. 951 (1978)).

98. 771 F.2d at 1130.

99. *Id.* at 1131.

100. *Id.*

101. See generally 3 COLLIER ON BANKRUPTCY, *supra* note 37, ¶ 523.05A (15th ed. 1984) (notes that the statute must be liberally construed in favor of the debtor).

The second approach rejected by the Eighth Circuit would clearly have violated this mandate. See *Hunter* at 1130 (punitive approach inappropriate).

102. 11 U.S.C. § 523(a)(6) mandates that a debt incurred in this manner is not discharged. The bankruptcy court's approach would have allowed the debtor to subvert this mandate.

### C. In re Long

The second Eighth Circuit case addressing the issue of dischargeability was *In re Long*.<sup>103</sup> The debtor's conduct in *Long* appears more egregious than that in *Hunter*, but the court held, however, that the entire debt was dischargeable.<sup>104</sup>

In *Long*, the debtor borrowed considerable sums to maintain the business.<sup>105</sup> The loans were, however, unable to sustain the business. In an effort to save the failing business, the debtor filed for reorganization under Chapter 11.<sup>106</sup> To pay reorganization expenses, the debtor transferred money from the creditor's secured collateral account.<sup>107</sup> The reorganization, however, failed, and the case was converted to Chapter 7.<sup>108</sup>

The creditor sought to prevent discharge of the loan. The creditor argued that the loan was obtained fraudulently by misrepresenting the value of the inventory.<sup>109</sup> Additionally, the creditor alleged that the transfer of money from the secured collateral account was a "wilfull and malicious" conversion of property.<sup>110</sup> The court rejected the creditor's claims and af-

103. 774 F.2d 875 (8th Cir. 1985).

104. *Id.* at 882. "Debtors who willfully break security agreements are testing the outer bounds of their right to a fresh start, but unless they act with *malice by intending or fully expecting to harm* the economic interests of the creditor, such a breach of contract does not, in and of itself, preclude a discharge." *Id.* (emphasis added).

105. *Id.* at 876. The debtor was A. & C. Johnson, a wholesaler of home improvement products. The president and majority stockholder, Long, however, had personally guaranteed the loans, thereby bringing himself within section 523. *Id.*

106. *Barclays American/Business Credit, Inc. v. Long (In re Long)*, 44 Bankr. 300, 304 (Bankr. D. Minn. 1983).

107. *Long*, 774 F.2d at 876. Long used the funds to pay attorney's fees and other reorganization costs. *Id.*

108. *Long*, 44 Bankr. at 304.

109. *Long*, 774 F.2d at 877-78; see 11 U.S.C. § 523(a)(2)(B) (1982 & Supp. II 1984). The creditor argued that discharge should be disallowed on the ground that the debtor fraudulently misrepresented the value of its inventory. *Long*, 774 F.2d at 877. The debtor's settled practice was to enter the price paid for inventory as market value of manufacturer's list price, even if the price actually paid was different. *Id.* The bankruptcy judge found an inherently inflationary effect on the valuation of the inventory whenever items of inventory were purchased at a discount. 44 Bankr. at 309. For instance, on one occasion, the debtor made a large purchase at a 90% saving. The cost, however, was assigned at the full value because that was the price previously used to calculate the item. 774 F.2d at 877.

110. *Long*, 774 F.2d at 879. The loan agreement had stated that proceeds from the secured accounts receivable were to be deposited in a special account for payment on the loan and were not to be commingled with the debtor's other funds.

The creditor also argued that the debts should not be discharged because the

firmed the discharge of all the debts. The court found that the debtor lacked the requisite "intent to deceive."<sup>111</sup>

The court prefaced its ruling with a brief discussion of the history of conversion under the dischargeability provision of the statute. The court determined that the statute requires the conversion to be both willful *and* malicious.<sup>112</sup> The standard articulated by the court states that "nondischargeability turns on whether the conduct is (1) headstrong and knowing ("willful") and, (2) targeted at the creditor ("malicious"), at least in the sense that the conduct is certain or almost certain to cause financial harm."<sup>113</sup> In applying this standard, the court said that the debtor's conduct was "unquestionably willful."<sup>114</sup> The court, however, did not believe that the debtor's actions were "malicious" in the context of the court's definition of the term.<sup>115</sup>

In reaching its decision, the Eighth Circuit reviewed the varied case law on "willful and malicious" conversion. An early Supreme Court decision held that any intentional act which is wrongful and causes injury is "willful and malicious."<sup>116</sup> Subsequently, the Supreme Court held that conversion by breach of contract does not affect dischargeability absent "aggravated

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"channeling of income from a segregated collateral account, . . . constitutes defalcation or fraud by a fiduciary . . . ." *Id.* at 878; *see also* 11 U.S.C. § 523(a)(4) (1982). The court rejected this contention because the term "fiduciary" only applies to express trusts in bankruptcy law. *Long*, 774 F.2d at 878-79. It held that "Barclays cannot soundly invoke the fiduciary bar against discharge of Long's obligation." *Id.* at 879.

111. *Long*, 774 F.2d at 882.

112. *Id.* at 880-81.

Congress tells us in § 523(a)(6) that malice and willfulness are two different characteristics. They should not be lumped together to create an amorphous standard to prevent discharge for any conduct that may be judicially considered to be deplorable. We are convinced that if malice, as it is used in § 523(a)(6), is to have any meaning independent of willful it must apply only to conduct more culpable than that which is in reckless disregard of creditors' economic interests and expectancies, as distinguished from mere legal rights.

*Id.*

113. *Id.* at 881

114. *Id.* The court recognized that Long knew he was breaching the loan agreement by transferring funds from the collateral account. *Id.*

115. *Id.* at 881-82. The court's definition requires the debtor to know or expect his conduct to cause financial harm to the creditor. In the present case, however, the creditor would have realized "hundreds of thousands of dollars" if Long's attempt to save the business had been successful. *Id.* at 882.

116. *Tinker v. Colwell*, 193 U.S. 473 (1904).

features."<sup>117</sup> Two distinct lines of cases have evolved from this "conflict." One line holds that any "intentional harm" to a creditor's legal rights, constitutes a "willful and malicious" conversion.<sup>118</sup> The second line holds that a breach of contract constitutes a "technical conversion" and the creditor must show specific intent to harm.<sup>119</sup> The Eighth Circuit adopted the strict malice test.<sup>120</sup>

By following the majority rule on this issue,<sup>121</sup> the *Long* case

117. *Davis v. Aetna Acceptance Corp.*, 293 U.S. 328, 332-33 (1934).

118. *Long*, 774 F.2d at 880; *see also* *United Bank of Southgate v. Nelson*, 35 Bankr. 766 (N.D. Ill. 1983).

119. *Long*, 774 F.2d at 880; *see also* *Impulsora Del Territoria v. Cecchini (In re Cecchini)*, 37 Bankr. 671 (Bankr. App. 9th Cir. 1984), *rev'd*, 772 F.2d 1493, *substituted opinion*, 780 F.2d 1440 (9th Cir. 1986); *In re Gallandet*, 46 Bankr. 918 (Bankr. D. Vt. 1985); *In re Levitan*, 46 Bankr. 380 (Bankr. E.D.N.Y. 1985); *In re Simpson*, 29 Bankr. 202 (Bankr. N.D. Iowa 1983).

120. The Eighth Circuit found that Congress intended the standard in *Tinker* to be abolished. *Long*, 774 F.2d at 879 n.4; *see* H. REP. NO. 595, 95th Cong., 1st Sess. 365, *reprinted in* 1978 U.S. CODE & AD. NEWS 5787, 5963, 6320-21. The court noted that "(u)nder this paragraph 'willful' means deliberate or intentional. To the extent that *Tinker v. Colwell*, 193 U.S. 473 (1902), held that a looser standard is intended, and to the extent that other cases have relied on *Tinker* to apply a 'reckless disregard' standard, they are overruled." H.R. Rep. No. 95-959, Cong., 1st Sess. 365 (1977); S. Rep. No. 95-989, 95th Cong., 2d Sess. 77-79 (1978), *reprinted in* U.S. CODE CONG. & AD. NEWS 5787, 6320 (1978).

Cases from other jurisdictions have held that "(a) careful reading of *Tinker* . . . does not disclose such a 'looser standard,' either for willfulness or malice." *Kuchinsky v. Trudeau (In re Trudeau)*, 35 Bankr. 185, 187 (Bankr. Mass. 1983); *accord* *United Bank of Southgate v. Nelson (In re Nelson)*, 35 Bankr. 766, 771-72 (N.D. Ill. 1983). The *Tinker* court merely defined willful as "intentional and voluntary." *Tinker*, 193 U.S. at 485.

The *Trudeau* court stated:

[I]n *United States v. Reed*, 86 Fed. 308, it was held that malice consisted in the willful doing of an act which the person doing it knows is liable to injure another, regardless of the consequences; and a malignant spirit or a specific intention to hurt a particular person is not an essential element. Upon that principle, we think a willful disregard of what one knows to be his duty, an act which is against good morals and wrongful in and of itself, and which necessarily causes injury and is done intentionally, may be said to be done willfully and maliciously, so as to come within the exception.

*Trudeau*, 35 Bankr. at 187.

The *Trudeau* court held that because of this language, the comments of Congress "should be reserved only for those cases that have misinterpreted *Tinker* to equate malice with recklessness." 35 Bankr. at 187. *But see* *Cecchini*, 37 Bankr. at 675; *Winkleman v. Fiedler (In re Fiedler)*, 28 Bankr. 28, 31 (Bankr. M.D. Pa. 1982); *Hodges*, 4 Bankr. at 514-15.

121. *Long*, 774 F.2d at 880-81. *Contra* *Nelson*, 35 Bankr. 766. *See generally* 1984 Annual Survey of Bankruptcy, Recent Developments in Decisions, Section 523-Exceptions to Discharge, 265, 288.

A distinct split has developed in American jurisdictions on whether to interpret the phrase "willful and malicious" to mean an intentional act which causes injury, *see*



seems to be a correct statement of the standard for denying discharge for conversion of property. The court, however, misapprehended the meaning of malice under the Act and ignored a clear trend in recent cases. The trend of the law seems to be that Congress intended implied or constructive malice to be applied in nondischargeability cases.<sup>122</sup> Nothing in the legislative history of section 523(a)(6) states that the malice in the statute must be an actual intent to do harm.<sup>123</sup> A standard of implied or constructive malice is consistent with the historical policy of discharging honest debtors.<sup>124</sup> The implied malice standard also eases the difficulty of proving subjective intent and malice.<sup>125</sup>

An implied malice test is in line with other types of cases decided under section 523(a)(c). For instance, at least one court held that damages resulting from an assault and a battery would be presumed to be intentional and malicious and not dischargeable.<sup>126</sup> The standard enunciated by the *Long* court is

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generally *Nelson*, 35 Bankr. 766; *Trudeau*, 35 Bankr. 185; *Car Village Buick-Opel, Inc. v. DeRosa* (*In re DeRosa*), 20 Bankr. 307 (Bankr. N.Y. 1982); *Simmons*, 9 Bankr. 62; *Birmingham Trust Nat'l Bank v. McGiboney* (*In re McGiboney*), 8 Bankr. 987 (Bankr. Ala. 1981); *The Farmers Bank v. McCloud* (*In re McCloud*), 7 Bankr. 819 (Bankr. Tenn. 1980); or an act performed with intent to cause injury. See *Long*, 774 F.2d 875; *In re Compos*, 768 F.2d 1155 (10th Cir. 1985); *Cecchini*, 37 Bankr. 671; *In re Hinkle*, 9 Bankr. 283 (Bankr. Md. 1981); *Liberty Nat'l Bank & Trust v. Hawkins* (*In re Hawkins*), 6 Bankr. 97 (Bankr. Ky. 1980); *Hodges*, 4 Bankr. 513.

The court in *Long* clearly followed this second approach, in demanding actual intent to harm. "Knowledge that legal rights are being violated is insufficient to establish malice, absent some additional aggravated circumstances . . . ."

*Long*, 774 F.2d at 880-81.

122. 1984 *Recent Developments*, *supra* note 121, at 288; see also *Nelson*, 35 Bankr. 766. In its analysis, the *Nelson* court determined that only part of the *Tinker* standard had been overruled and that the constructive malice part of the case was still viable. *Id.* at 774-75.

123. *Nelson*, 35 Bankr. at 771; see also *United Va. Bank v. Fussell* (*In re Fussell*), 15 Bankr. 1016, 1022 (W.D. Va. 1981); 1984 *Recent Developments*, *supra* note 121, at 292-93.

124. *Nelson*, 35 Bankr. at 776.

125. *Id.*; but see *Long*, 774 F.2d at 881. This factor was dismissed by the *Long* court, which said that "(w)hile intentional harm may be very difficult to establish, the likelihood of harm in an objective sense may be considered in evaluating intent." *Id.*

126. *Trudeau*, 35 Bankr. at 187-88; but see *Pargas v. Poore* (*In re Poore*), 37 Bankr. 246 (Bankr. D.N.M. 1982).

The conduct of the Defendant clearly approaches the outer limits of negligence. It was certainly wanton and in reckless disregard of the lives and safety of others. Further, his conduct was well within the area where criminal punishment is appropriate. The question, however, is whether it is ". . . willful and malicious injury by the Debtor to another . . ." within the ambit of 11 U.S.C. § 523(a)(6).

rigorous and will not be met, absent actual subjective intent on the part of the debtor to willfully and maliciously convert the creditor's funds. In its efforts to protect the debtor, the court overlooked the justifiable expectations of the creditor.

The most significant area of development has occurred in the cases of damage arising from drunk driving.<sup>127</sup> Under section 523(a)(6) the cases are split on whether such damages should be dischargeable.<sup>128</sup> A 1984 amendment solved this

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*Id.* at 247. The court in *Poore* went on to hold that the debt was dischargeable. *Id.* at 250.

127. See *Moraes v. Adams (In re Adams)*, 761 F.2d 1422 (9th Cir. 1985) (voluntary acts of drinking and driving constitute conduct sufficiently intentional to support willfulness and malice and thus damages were nondischargeable). But see *Compos*, 768 F.2d 1155 (debt was dischargeable where creditors proved that an intoxicated driver's conduct was in reckless disregard of the rights and did not prove that debtor intended to injure).

128. Cases which allowed discharge include: *Gunther v. Kuepper (In re Kuepper)*, 36 Bankr. 680 (Bankr. E.D. Wis. 1983); *Marwell Trucking, Inc. v. Davis (In re Davis)*, 26 Bankr. 580 (Bankr. D.R.I. 1983); *Lee v. Silas (In re Silas)*, 24 Bankr. 771 (Bankr. N.D. Ala. 1982); *In re Maney*, 23 Bankr. 61 (Bankr. W.D. Okla. 1982); *Castiglia v. Morgan (In re Morgan)*, 22 Bankr. 38 (Bankr. D. Neb. 1982); *Security Mut. Casualty Co. v. Rainey (In re Rainey)*, 1 Bankr. 569 (Bankr. D. Or. 1979).

Cases, on the other hand, which disallowed discharge include: *Caldarelli v. Callaway (In re Callaway)*, 41 Bankr. 341 (Bankr. E.D. Pa. 1984); *Tobler v. Carey (In re Carey)*, 35 Bankr. 894 (Bankr. E.D. Tenn. 1983); *Burns v. Cloutier (In re Cloutier)*, 33 Bankr. 18 (Bankr. D. Me. 1983); *Prosch v. Wooten (In re Wooten)*, 30 Bankr. 357 (Bankr. N.D. Ala. 1983); *Long v. Greenwell (In re Greenwell)*, 21 Bankr. 419 (S.D. Ohio 1982). One court has stated:

Whether driving while intoxicated—with or without knowledge of the probable consequences—constitutes conduct that is "willful" and "malicious" would present a close question if we were limited in our interpretation of section 523(a)(6) to the language of that subsection and the legislative history in existence at the time the matter was decided in the district court.

*Adams*, 761 F.2d at 1426 (interpreting section 523(a)(9) to give rise to a presumption of malice in cases of debts arising from drunk driving accidents)

However, two months after judgment was entered Congress answered the question in the form of an amendment to Title 11. In July of 1984, Congress enacted 11 U.S.C. § 523(a)(9) which, in our view, prescribes the manner in which we must construe section 523(a)(6). See *May Dep't Stores Co. v. Smith*, 572 F.2d 1275, 1278 (8th Cir.) (per curiam), cert. denied, 439 U.S. 837, 99 S. Ct. 122, 58 L.Ed.2d 134 (1978) (subsequent amendment and its legislative history, though not controlling, is nonetheless entitled to substantial weight in construing the earlier law). Section 523(a)(9) provides explicitly that debts arising from liabilities incurred as a result of drunk driving are nondischargeable. The legislative history underlying the 1984 amendment makes it clear that by enacting the amendment, Congress intended to clarify preexisting law. . . . In addition to the expression of Congressional intent underlying section 523(a)(9), we are influenced by the fact that at the time that amendment was enacted there was a clear conflict among the *nisi prius* courts, in this case the bankruptcy courts, over the meaning of section 523(a)(6). See pp. 1425-1426, *supra*. With respect to statutory construction,

problem with the revision of subsection nine.<sup>129</sup> This section makes it clear that malice is to be presumed and the debts are not discharged.<sup>130</sup> Cases construing the nondischargeability of debts arising from drunk driving have held that malice may be implied.

Finally, allowing an implied or constructive malice test helps effectuate the policy underlying the preferred position of secured creditors in a bankruptcy proceeding.<sup>131</sup> A test that requires actual subjective malice to be proved renders the security interest meaningless and places the secured creditor in no better position than the unsecured creditor.<sup>132</sup>

In conclusion, the Eighth Circuit in *Long* enunciated a standard that is extremely difficult to attain and that invites abuse. The policy of protecting the debtor was placed at such a premium in this case that all other considerations were

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we view conflict among courts as an indication that a subsequent amendment is intended to clarify, rather than change, the existing law.

*Id.* at 1426-27 (footnote omitted). *Contra Compos*, 768 F.2d 1155 (requires proof of intent to injure before a debt is held nondischargeable). Since the revised section 9 had not officially gone into effect, the court had to decide the case under section 6. Unlike the *Adams* court, however, the *Compos* court declined to recognize the amendment persuasively.

129. See *supra* note 82 (quotes section 523).

130. In describing the various Bankruptcy Code Amendments that were being adopted, the Chairman of the House Committee of the Judiciary stated that "[section 523(a)(9)] clarifies present law relating to the nondischargeability of debts incurred by drunk drivers. Debts incurred by persons driving while intoxicated are presumed to be willfully and maliciously incurred under this provision." 130 Cong. Rec. H7489 (daily ed. June 29, 1984) (statement of Rep. Rodino), reprinted in 1984 U.S. Code Cong. & Ad. News 576, 577.

. . . remarks of Senator DeConcini on the Senate floor in support of his proposed amendment to change the existing law to deny bankruptcy discharges to debtors who have incurred liabilities for injury and damage to persons and property resulting from driving while intoxicated:

. . . I have an amendment that would change the standard and would not permit discharge in bankruptcy of obligations arising from the infliction of willful, wanton, or reckless injury. Today, there exists in the bankruptcy statute an unconscionable loophole which makes it possible for drunk drivers or others who have acted with willful, wanton, or reckless conduct and who have injured, killed, or caused property damage to others to escape civil liability for their actions by having their judgment debt discharged in Federal bankruptcy court. This loophole affords opportunity for scandalous abuse . . . (citations omitted).

*Dreiling*, 768 F.2d at 1158.

131. *Nelson*, 35 Bankr. at 776. The intent to harm standard places a nearly insurmountable burden on creditors by allowing the debtor to misappropriate the collateral and then forcing the creditor to prove subjective intent to harm. *Id.* In effect, this can destroy the creditor's security interest because the creditor will have little control over the disposition of the property. *Id.*

132. *Id.*

subordinated. A standard that would allow implied malice, which is the trend of the law, would still allow adequate protection to the debtor who in good faith technically converts property,<sup>133</sup> while offering a greater measure of protection to the secured creditor who is relying on the pledged property when making loans.<sup>134</sup>

### III. ATTEMPTS TO AVOID LIENS CREATED BY MARRIAGE DISSOLUTION

In two recent cases, the Eighth Circuit interpreted section 522(f) of the Code, which allows a debtor to avoid liens placed on certain property.<sup>135</sup> In the first case, *In re Thompson*, the court interpreted the provision allowing liens to be avoided if the property involved is primarily for personal use.<sup>136</sup>

In the second case, *Boyd v. Robinson*,<sup>137</sup> the court held that a lien created by a family court to protect one party of a divorce

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133. 1984 *Recent Developments*, *supra* note 121, § 523, at 293; *see Nelson*, 35 Bankr. at 776; *see also* *Dunkinson v. Ricketts (In re Ricketts)*, 40 Bankr. 676 (Bankr. D. Md. 1984). A technical conversion has been defined to be one that lacks the elements of willfulness and maliciousness necessary to avoid discharge. *The Howard Bank v. Davis (In re Davis)*, 11 Bankr. 156 (Bankr. D. Vt. 1980).

134. *See Nelson*, 35 Bankr. at 776.

135. Section 522(f) provides, in pertinent part:

(f) Notwithstanding any waiver of exemptions, the debtor may avoid the fixing of a lien on an interest of the debtor in property to the extent that such lien impairs an exemption to which the debtor would have been entitled under subsection (b) of this section, if such lien is—

- (1) a judicial lien; or
- (2) a nonpossessory, nonpurchase-money security interest in any—
  - (A) household furnishings, household goods, wearing apparel, appliances, books, animals, crops, musical instruments, or jewelry that are held primarily for the personal, family, or household use of the debtor or a dependent of the debtor;

11 U.S.C. § 522(f) (1982).

136. *See In re Thompson*, 750 F.2d 628 (8th Cir. 1984). In *Thompson*, the court held that a lien on certain pigs owned by the debtor/farmer was not avoidable because the pigs could not properly be considered property used primarily for personal, family or household use. *Id.* at 631; *see* 11 U.S.C. § 522(f)(2)(A) (1982). The court noted that the general purpose of the lien avoidance provision is to allow debtors to extricate themselves from adhesion contracts. 750 F.2d at 630. *See S. REP. NO. 989*, 95th Cong., 2d Sess. 126-27, *reprinted in* 1978 U.S. CODE CONG. & AD. NEWS 5787, 6087-88 (discusses problem of adhesion contracts and the need to protect debtors). The court concluded that only those goods necessary to the debtor's new beginning and that were of relatively little value were to be exempt from liens. 750 F.2d at 631. The court held that the pigs, which were really business property of the debtor, did not fit into this category. *Id.*

137. 741 F.2d 1112 (8th Cir. 1984).

was not avoidable.<sup>138</sup> In order to avoid a lien under section 522(f)(1), it must be established that (1) the lien attach to an interest of the debtor in exempt property; and (2) the lien must be a judicial lien.<sup>139</sup> The *Boyd* court held that the first requirement was not satisfied since the interest created in the nonresident spouse was preexisting, and therefore, did not attach to any part of the debtor's property.<sup>140</sup>

Since the *Boyd* court held that the lien did not attach to an interest of the debtor in exempt property, it logically followed that the lien could not be avoided.<sup>141</sup> This outcome is sound both in logic and policy. Not only does this rule allow the property of the parties to be treated separately, it also protects the lienholder from being deprived of that person's rightful

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138. *Id.* at 1113-14.

139. *Id.* at 1113.

140. *Id.* at 1113-14. The majority of the courts that have addressed this issue have similarly held that a former spouse's lien on the debtor's homestead may not be avoided. See *In re Maus*, 48 Bankr. 948 (Bankr. D. Kan. 1985); *Seablom v. Seablom* (*In re Seablom*), 45 Bankr. 445 (Bankr. D.N.D. 1984); *In re Thomas*, 32 Bankr. 11 (Bankr. D. Or. 1983); *In re Graham*, 28 Bankr. 928 (Bankr. N.D. Iowa 1983); *McCormick v. Mid-State Bank & Trust Co.*, 22 Bankr. 997 (W.D. Pa. 1982); *Cowan v. Cowan* (*In re Scott*), 12 Bankr. 613 (Bankr. W.D. Okla. 1981); *Dunn v. Dunn* (*In re Dunn*), 10 Bankr. 385 (Bankr. W.D. Okla. 1981). Cf. *In re Chesnut*, 50 Bankr. 309 (Bankr. W.D. Okla. 1985) (lien on homestead created in favor of attorney who represented spouse in dissolution is avoidable because it does not represent a preexisting property interest); *Thomas v. Lyles* (*In re Thomas*), 47 Bankr. 27, 33 (Bankr. S.D. Cal. 1984) (bankruptcy court has no power to modify separate property interest of ex-spouse in portion of military pension); *Butts v. Butts* (*In re Butts*), 46 Bankr. 292, 296 (Bankr. D.N.D. 1985) (equitable lien to protect one spouse where the other spouse obtained a favorable settlement by duplicity and subsequently tried to avoid their obligation by filing bankruptcy).

Compare 11 U.S.C. § 522(f) (1982) (lien avoidance) with 11 U.S.C. § 523(a)(5) (1982 & Supp. II 1984) (nondischargeability of marital obligations). The cases dealing with lien avoidance in this context often touch on the nondischargeability of marital obligations as an additional basis for holding the lien unavoidable. The doctrines have often become intertwined.

Holding a lien in favor of the nonresident ex-spouse unavoidable helps to effectuate the relevant policies behind both sections.

141. 741 F.2d at 1114. "The proposition that a spouse has a property interest in homestead property acquired during the marriage is hardly startling or unique to Minnesota." *Id.* Judge Ross, in his dissent, reasoned that the preexisting property interest held by the nonresident former spouse was extinguished at the time of the marriage dissolution. *Id.* at 1115. The lien created at the time was a new interest and therefore attached to an interest in exempt property. *Id.*

Judge Ross' dissent, however, ignores the proposition that the lien in favor of the nonresident spouse merely represents a form of division of the marital property under state law. Since the lien only represented the preexisting and continuing interest in the marital property, logic and equity indicated that the lien should not be subject to avoidance.

share of the marital property by a dishonest spouse who intentionally files bankruptcy for the purpose of avoiding the obligation of a property settlement.<sup>142</sup>

In conclusion, the Eighth Circuit joined the other courts that have addressed this issue in holding that a lien on a homestead created in favor of a former spouse represents a preexisting interest. As a result, the lien is not avoidable under section 522(f)(1).

#### IV. ADEQUATE PROTECTION

In a trilogy of recent cases, the court addressed the issue of adequate protection in various situations. In *re Martin*<sup>143</sup> dealt with the issue of adequate protection of a creditor under a plan for reorganization.<sup>144</sup> In *Martin*, the debtors/farmers filed petitions for reorganization under Chapter 11.<sup>145</sup> Later, the debtors requested the use of cash collateral to finance continued operation and to plant the next year's crop.<sup>146</sup> In order to obtain the needed cash, the debtors wanted to sell mortgaged grain that was stored on their premises in exchange for a first lien on the next year's crop and an assignment of the proceeds of their Federal Crop Insurance policies.<sup>147</sup> The computed value of the nonexistent crop was deemed to exceed the value of the requested collateral.<sup>148</sup> The bankruptcy court granted

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142. See, e.g., *Butts*, 46 Bankr. at 296; but see *Boyd*, 741 F.2d at 1116 (Ross, J., dissenting) ("While I agree that permitting avoidance of this lien is a harsh result, I cannot in conscience join the majority. This type of decision is for Congress. Once Congress has decided, its judgment should be respected.").

143. 761 F.2d 472 (8th Cir. 1985).

144. Section 361 provides, in pertinent part:

When adequate protection is required . . . such adequate protection may be provided by—

(1) requiring the trustee to make periodic cash payments to such entity, to the extent that the stay . . . [or] use, . . . results in a decrease in the value of such entity's interest in such property;

(2) providing to such entity an additional or replacement lien to the extent that such . . . use . . . results in a decrease in the value of such entity's interest in such property; or

(3) granting such other relief, . . . as will result in the realization by such entity of the indubitable equivalent of such entity's interest in such property.

11 U.S.C. § 361 (1982).

145. *Martin*, 761 F.2d at 473.

146. *Id.*

147. *Id.*

148. *Id.* at 473-74. The bankruptcy court found that the creditors were "virtually

the debtor's motion and the creditor appealed.<sup>149</sup> The district court reversed, holding the proposed lien and assignment of insurance on the unplanted crop adequately protected the creditor.<sup>150</sup>

On appeal, the court held that adequate protection of the creditor is a question of fact.<sup>151</sup> The court, after lengthy discussion, remanded the case to the bankruptcy court with instructions to apply the correct legal standard and determine if there was, in fact, adequate protection.<sup>152</sup>

In formulating the legal standard by which adequate protection is to be determined, the court noted that the proposal for the use of collateral, as nearly as possible, provide the creditor with the benefit of his bargain.<sup>153</sup> The court formulated a three-part standard that a bankruptcy court must follow in determining if the plan provides adequate protection.<sup>154</sup> First, the court must establish the value of the secured creditor's interest.<sup>155</sup> The court must then identify the risks to the secured creditor's value resulting from the debtor's proposed use of the collateral.<sup>156</sup> Lastly, the bankruptcy court must determine whether the debtor's proposal protects the "value as nearly as possible against risks to that value consistent with the concept

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certain" to get a return of their interest because they had a first lien on the nonexistent crop and had an interest in the Federal Crop Insurance policy. *Id.*

149. *Id.*

150. A threshold issue addressed by the court was whether the issue was moot because the case was not argued until after the disputed crop year had come to an end. *Id.* The court held that the case fell within the "capable of repetition, yet evading review" exception to the mootness rule. *Id.*; see *Globe Newspaper Co. v. Superior Court*, 457 U.S. 596, 602-03 (1982); *Flittie v. Erickson*, 724 F.2d 80, 82 (8th Cir. 1983).

151. *Martin*, 761 F.2d at 474.

152. *Id.* at 478-79.

153. *Id.* at 476; (quoting *In re American Mariner Indus., Inc.*, 734 F.2d 426, 435 (9th Cir. 1984)). The court examined the legislative history behind section 361 and found that the concept of adequate protection was a flexible one. *Martin*, 761 F.2d at 476. The court cautioned, however, that the flexibility should not work to the detriment of the secured creditor and that the adequate protection provided must be the "indubitable equivalent" of the creditor's interest. *Id.*

154. *Martin*, 761 F.2d at 476-77.

155. *Id.* The bankruptcy court, in this case, failed to do that. In computing the value, the court did not use any documentary evidence to back up the results. *Id.*

156. *Id.* Again the bankruptcy court failed to identify any of the attendant risks to the creditor. The proposed collateral was a nonexistent cash grain crop. The bankruptcy court failed to take into account many contingencies that might have occurred which would have damaged or destroyed the creditor's interest. *Id.*

of indubitable equivalence.”<sup>157</sup> Since the bankruptcy court did not consider the case by the appropriate standard, the court remanded for a factual determination.<sup>158</sup> Although only dicta, the court expressed obvious disapproval for allowing the debtor to speculate with the creditor’s collateral.<sup>159</sup>

The obvious implication of this case is to limit the ability of bankruptcy judges to approve plans as providing adequate protection where the protection afforded the secured creditor is speculative.<sup>160</sup> The court’s ruling will force the bankruptcy courts to have objective justification for allowing debtors to risk creditor’s interests.

The second case that dealt with this issue was *In re Monnier Brothers*.<sup>161</sup> In *Monnier*, the debtors were loaned large amounts of money by the creditor for their farming operation.<sup>162</sup> The debtor eventually filed for reorganization under Chapter 11.<sup>163</sup> The court invoked the “cram down”<sup>164</sup> provision and affirmed

157. *Id.* Since this third factor is an incorporation of the first two, it is obvious that the bankruptcy court did not consider it. *Id.*

158. *Id.* at 478-79. The court remanded for a factual determination, but said in dicta: “[W]e believe that the bankruptcy court ‘accord(ed) insufficient weight to the language of the statute and the Congressional goal of affording the secured creditor the benefit of its bargaining.’” *Id.* at 478.

159. *See id.* at 477.

160. *See id.*

161. 755 F.2d 1336 (8th Cir. 1985).

162. *Id.* at 1337. The note was secured by a mortgage upon the debtor’s farmland. The loan agreements set the interest rate at 13% per annum, with an increase to 15% on overdue installments. *Id.*

163. *Id.*

164. *See* 755 F.2d at 1338. The “cramdown” provision is embodied in 11 U.S.C. § 1129(b) (1982 & Supp. II 1984). The provision allows the court to adopt a plan of reorganization over the objection of a creditor. The court quoted the provision as follows:

(b)(1) the plan does not discriminate unfairly, and is fair and equitable, with respect to each [dissenting] class . . .

(2) For the purpose of this subsection, the condition that a plan be fair and equitable with respect to a class includes the following requirements:

(A) With respect to a class of secured claims, the plan provides—

(i)(I) that the holders of such claims retain the liens securing such claims, whether the property subject to such liens is retained by the debtor or transferred to another entity, to the extent of the allowed amount of such claims; and

(II) that each holder of a claim of such class receive on account of such claim deferred cash payments totaling at least the allowed amount of such claim, of a value as of the effective date of the plan, of at least the value of such holder’s interest in the estate’s interest in such property; [or]

(iii) for the realization by such holders of the *indubitable equivalent* of such claims.



the plan over the creditor's objection.<sup>165</sup> The plan called for a reduction of the interest rate paid to the creditor. The district court affirmed confirmation of the plan but reversed the interest determination.<sup>166</sup> The district court held that the debtor should repay the loan at the rate set out in the mortgage.<sup>167</sup>

In its discussion on the issue, the Eighth Circuit suggested that the Code is not very helpful in determining the appropriate interest rate.<sup>168</sup> The court further noted that neither party in this case had been of much assistance to the court in determining the appropriate interest rate.<sup>169</sup> The court went on to affirm the district court's allowance of the contract rate in this case, stating merely that the court had not erred in its determination.<sup>170</sup>

For the second time in the survey period, the court refused to squarely address the adequate protection issue. In both

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*Id.* at 1338 n.2. (emphasis added).

It should be noted that ten other classes of creditors, most of whom held fully secured claims, accepted the plan. *Id.* at 1337. The objecting creditor opposed because the plan did not provide for immediate payment and because the court changed the interest terms of the note. *Id.* at 1338. Under the confirmed plan, the creditor would receive payments at the default rate for the time period prior to the confirmation and would receive 10.5% for the remainder. *Id.* The interest rate determined by the bankruptcy court represented the current United States Treasury discount rate. *Id.*

165. *Id.* at 1338.

166. *Id.*

167. *Id.*

168. *Id.* One of the Code's few clues about what factors to take into account in selecting an appropriate interest rate appears in § 1129(b)(2)(A)(iii); that section states that a plan may be confirmed over the objections of a secured creditor if the plan affords the creditor the "indubitable equivalent" of his claim. 11 U.S.C. § 1129(b)(2)(A)(iii). Legislative history indicates Congress intended this phrase to take on the meaning given it by Judge Learned Hand in *In re Murel Holding Co.*, 75 F.2d 941, 942 (2d Cir. 1935). *Mariner*, which is cited in *Monnier*, quoted and analyzed Judge Hand's commentary on this issue.

Judge Hand concluded that the creditor's right "to get his money or at least the property" may be denied under a plan for reorganization only if the debtor provides "a substitute of the most indubitable equivalence." *Such a substitute clearly must both compensate for present value and insure the safety of the principal.* (emphasis in original)

*Monnier*, 755 F.2d at 1339 (quoting *Mariner*, 734 F.2d at 433).

169. See *Monnier*, 755 F.2d at 1339. The creditor had insisted that since it was oversecured, it was entitled to the contract rate as a matter of law. *Id.* at 1338. Conversely, the debtor had asserted that the discount rate was appropriate (quoting *Mariner*, 735 F.2d at 443). The court rejected both of these positions. *Id.*

170. *Id.* The court seemed to limit its holding to the facts. Since the parties had not supplied the court with appropriate data to determine a fair interest rate, the court held that as between the two figures supplied, the contract rate was the most appropriate. *Id.*

*Martin* and *Monnier*, the court favorably cited a recent Ninth Circuit case which did not address the issue, without expressly adopting or rejecting its analysis.<sup>171</sup> That discussion was left to the third significant Eighth Circuit case on this issue.

The Eighth Circuit decided *In re Briggs Transportation Co.*<sup>172</sup> at the end of the survey period. The issue addressed by the court in *Briggs* was "whether the concept of 'adequate protection' found in 11 U.S.C. §§ 361 and 362 entitles undersecured creditors as a matter of law to interest payments from a debtor to compensate the creditors for lost opportunity costs due to the delay in reinvesting the collateral's liquidated value caused by an automatic stay."<sup>173</sup> The bankruptcy court held that interest was not available as adequate protection.<sup>174</sup> The district court reversed, holding that undersecured creditors were entitled to interest as a matter of law.<sup>175</sup> The Eighth Circuit held that neither of these positions was correct.<sup>176</sup> The court chose a middle position which affirmed the award of interest in this case, but the court did not require or deny it as a matter of law in any other cases.<sup>177</sup>

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171. *Mariner*, 734 F.2d at 433-34; see *Martin*, 761 F.2d at 476; *Monnier*, 755 F.2d at 1339.

172. 780 F.2d 1339 (8th Cir. 1985).

173. *Id.* at 1340. Briefly stated, the facts of the case show that the debtor filed a petition for reorganization under which the complaining creditors held a secured claim on some of the debtor's property. *Id.* at 1391. Both creditors' claims were undersecured. The creditors sought "adequate protection in the form of interest payments to compensate for their 'lost opportunity costs.'" *Id.*

174. *Id.*; see *Lend Lease v. Briggs Transp. Co. (In re Briggs Transp. Co.)*, 35 Bankr. 210, 216-17 (Bankr. D. Minn. 1983).

175. *Briggs*, 780 F.2d at 1341. The district court adopted the rationale of *Mariner*, 734 F.2d 426 (9th Cir. 1983), which stated that a secured creditor "is entitled to compensation for the delay in enforcing its rights during the interim between the petition and confirmation of the plan." *Id.* at 435.

176. See *Briggs*, 780 F.2d at 1350-51.

177. The court noted that "adequate protection" must be a flexible concept. *Id.* at 1348. Therefore, the court reasoned an award of interest should be determined on a case by case basis:

We recognize that a rule which directs courts to approach adequate protection analyses on a case-by-case basis provides minimal guidance for future reconstruction by courts of a secured creditor's bargain for adequate protection purposes. However, the developing case law applying the provisions of the Bankruptcy Code of 1978 has already devised a broad variety of equitable considerations which provide a guide for future cases. Obviously, situations involving a greatly oversecured claim will be quite different from cases such as this involving undersecured claims, and a value determination for automatic stay purposes is not necessarily the same as value determined for another purpose, such as confirming a plan.

*Id.* at 1349. The court concluded that a per se rule was inappropriate:

The Eighth Circuit noted that a split of authority exists in the courts on this issue.<sup>178</sup> Declining to follow either of the existing lines of authority, the court adopted a case-by-case approach.<sup>179</sup>

Vigorously dissenting, Judge Gibson argued that the majority's approach creates uncertainty and provides no guidance for bankruptcy courts in their determination of this issue.<sup>180</sup> As a result of the majority's decision in *Briggs*, lower courts have great latitude in deciding the issue of adequate protection. This comports with *Martin*, which pointed out that adequate protection is essentially a fact question which must be resolved by the fact finder.<sup>181</sup> However, *Briggs* also creates a great uncertainty by providing wide discretion without providing guidance on how it should be resolved.<sup>182</sup> This latitude

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After careful consideration of the Bankruptcy Code's language and legislative history and of underlying policy considerations, we cannot hold as a matter of law that a creditor is always entitled to compensation for the delay in enforcing its foreclosure rights during the interim period between filing of a petition and confirmation of a plan. Although the concept of adequate protection under sections 361 and 362 requires the court to protect the creditor's allowed secured claim by compensating for any loss of value of the collateral, what constitutes adequate protection in a particular case is a question whose resolution is best left to the knowledge and expertise of the bankruptcy court.

*Id.* at 1350-51.

178. *Id.* at 1342. Compare *American Mariner Indus.*, 734 F.2d at 435 (the payment of interest one method of providing adequate protection) with *U.S. v. Smithfield Estates (In re Smithfield Estates)*, 48 Bankr. 910, 914-15 n.8 (Bankr. R.I. 1985) (declining to award interest as part of the creditor's adequate protection). The *Mariner* rationale has been applied in a number of recent cases and seems to be the trend of the cases. See, e.g., *Grundy Nat'l Bank v. Tandem Mining Corp.*, 754 F.2d 1436, 1440-41 (4th Cir. 1985).

179. 780 F.2d at 1350-51. Since adequate protection is deemed to be a flexible concept by the Eighth Circuit, the court reasoned it was appropriate to analyze the interest question on a case-by-case basis. See *id.*

180. *Id.* at 1351 (Gibson, J., dissenting). Judge Gibson argued that the preferable course was that adopted by the Ninth Circuit in *Mariner*. *Id.* *Mariner* makes clear that the creditor is entitled to some compensation as a matter of law. See *Mariner*, 734 F.2d at 435. The compensation need not take the form of regularly recurring interest payments but must simply compensate the creditor for future use of the collateral's value. *Id.*; see *Briggs*, 780 F.2d at 1351. Judge Gibson argues that this is the most sensible approach since it assures protection of creditors and also gives the bankruptcy court's guidance on the issue of interest entitlement. See *id.* at 1351-52. Under the *Mariner* rule, the bankruptcy court need only decide what form the protection is to take and not whether it should be awarded in the first instance. See *id.*; but see *Briggs*, 780 F.2d at 1350 n.12 (majority opinion charges that the dissent reads *Mariner* case-by-case approach too narrowly).

181. *Martin*, 761 F.2d at 474.

182. The court did note that a determination depended on the balancing of competing interests. *Briggs*, 780 F.2d at 1349. The court noted factors such as the "na-

can create uncertainty and hesitancy in planning by secured creditors who will be unsure of the amount and type of protection they will be afforded in the event a debtor files for reorganization.<sup>183</sup>

## V. OTHER SIGNIFICANT DEVELOPMENTS

### A. *Bad Faith Filing of Involuntary Petitions*

In the eighteen month period covered by this survey, the court issued several other significant opinions. In *Basin Electric Power Cooperative v. Midwest Processing Co.*,<sup>184</sup> the court construed section 303(b)(1) of the Bankruptcy Code.<sup>185</sup> In *Basin Electric*, a single creditor filed an involuntary petition against the debtor, knowing that the debtor had more than twelve creditors.<sup>186</sup> The court affirmed the finding that the petition had been filed in bad faith and should therefore be dismissed.<sup>187</sup> By adopting the good faith requirement in filing requirements, the court emphasized that any other holding would make the three creditor filing requirement a meaningless formality.<sup>188</sup>

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ture of the collateral and the proposed use of the collateral . . . ." as being significant. *Id.* The court did not, however, give any concrete guidance on this issue.

183. 780 F.2d at 1351 (Gibson, J., dissenting). "[T]he court today leaves both the question of entitlement and the determination of the proper method of protection to the bankruptcy court. The weakness of the court's position is that it sets free the bankruptcy court without guidance whatsoever on the entitlement issue." *Id.* (footnote omitted).

184. 769 F.2d 483 (8th Cir. 1985).

185. Section 303 provides in pertinent part:

(b) An involuntary case against a person is commenced by the filing with the bankruptcy court of a petition

(1) by three or more entites, each of which is . . . a holder of a claim

(2) if there are fewer than 12 such holders, . . . by one or more of such holders . . .

(c) After the filing of a petition under this section but before the case is dismissed or relief is ordered, a creditor holding an unsecured claim . . . may join in the petition with the same effect as if such joining creditor were a petitioning creditor under subsection (b) of this section.

11 U.S.C. § 303 (1982 & Supp. II 1984).

186. *See Basin*, 769 F.2d at 484.

187. *Id.* at 486-87. Bankruptcy Rule § 1003(d) provides that if the debtor answers the involuntary petition by alleging the existence of 12 or more creditors, the court shall afford an opportunity for other creditors to join the petition. The court's holding limits this rule to the extent that it requires an element of good faith on the part of the filing creditor(s).

188. *See id.* at 486. The court recognized that if the petition is filed with a good faith belief that the debtor had fewer than 12 creditors, the petition could be cured

### B. *Frivolous Appeals*

In the case of *In re Nordbrock*,<sup>189</sup> the Eighth Circuit awarded attorney's fees to the debtor when the creditor appealed an adverse ruling from the bankruptcy court, through the district court and to the Eighth Circuit.<sup>190</sup> The debtor asked the district court to assess attorney's fees pursuant to section 303(i).<sup>191</sup> The district court affirmed the bankruptcy court's decision in favor of the debtor but denied assessing attorney's fees.<sup>192</sup>

The creditor appealed and the Eighth Circuit affirmed the lower court's decisions in all respects.<sup>193</sup> The debtor cross appealed, asking for attorney's fees either under section 303(i) or under Rule 38 of the Federal Rules of Appellate Procedure.<sup>194</sup> The court ruled that the lower court's denial of attorney's fees under section 303(i) was not clearly erroneous and was therefore affirmed.<sup>195</sup> The court, however, determined that the creditor's appeal to the appellate court was frivolous and therefore granted attorney's fees under Rule 38.<sup>196</sup> The court

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by allowing the others to join. *See id.*; *see also* 2 COLLIER ON BANKRUPTCY, *supra* note 137, ¶ 303.08 (15th ed. 1985).

Other jurisdictions also recognize a good faith requirement to the filing provisions. *See, e.g., In re Crown Sportswear*, 575 F.2d 991, 994 (1st Cir. 1978) (court found no evidence of bad faith).

189. 772 F.2d 397 (8th Cir. 1985).

190. *Id.* at 400. In *Nordbrock*, the creditor filed an involuntary petition on the grounds that the debtor was generally not paying his debts as they became due. *Id.* at 399.

191. Title 11 U.S.C. § 303(i) provides that the court may award costs and attorneys' fees under certain circumstances to the debtor if the petition is dismissed. It provided that:

(i) If the court dismisses a petition under this section other than on consent of all petitioners and the debtor, and if the debtor does not waive the right to judgment under this subsection, the court may grant judgment—

(1) against the petitioners and in favor of the debtor for—

(A) costs;

(B) a reasonable attorney's fee; or

(C) any damages proximately caused by the taking of possession of the debtor's property by a trustee . . . .

11 U.S.C. § 303(i) (1982).

192. *Nordbrock*, 772 F.2d at 400.

193. The court, in its affirmance of the lower courts, held that the district court did not abuse its discretion in denying attorneys' fees under section 303(i). *Id.*

194. Rule 38 authorizes an award of attorneys fees as "just damages" for a frivolous appeal. FED. R. APP. P. 38.

195. *Nordbrock*, 772 F.2d at 400.

196. *See Id.* at 400. The court stated that:

Although Bankers Trust's appeal to the district court can be considered nonfrivolous, its further appeal to this court cannot be justified in light of

held that the creditor "should clearly have been on notice from the existing case law that it stood little chance of prevailing . . . ." <sup>197</sup>

This case presents difficult problems for the practitioner in bankruptcy court. Bankruptcy court structure adds one level to the appeals process not existing in other types of suits. The court made reference to the creditor taking an unnecessary "third bite" of the litigation apple.<sup>198</sup> This situation must be considered by anyone who is challenging existing rules of law in the bankruptcy area. Most suits brought in the federal court system progress from the district to the circuit court. With the addition of a third level for bankruptcy cases, the circuit courts will be understandably less lenient with obviously weak appeals. Practitioners should be forewarned that if, after defeat in the bankruptcy and district court, the client wishes to appeal, the risk of being assessed costs is greatly increased.

### C. Chapter 11 Issues

Several recent cases have dealt with various aspects of Chapter 11 reorganization petitions. In *In re Clarkson*,<sup>199</sup> the court addressed the issue of feasibility of a plan for reorganization.<sup>200</sup> In *Clarkson* the Eighth Circuit reaffirmed the notion that "the feasibility test is firmly rooted in predictions based on objective fact."<sup>201</sup> The court stated that "sincerity, honesty, and willingness are not sufficient to make the plan feasible."<sup>202</sup> In applying the objective test, the court said that pertinent factors to consider in determining if the plan is feasible include earning power, capital structure, economic conditions, managerial efficiency and whether current management would con-

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the existing case law and the district court's thorough and well-reasoned opinion considering and rejecting the principle authorities relied on by Bankers Trust.

*Id.*

197. *Id.* at 400.

198. *See Id.*

199. 767 F.2d 417 (8th Cir. 1985).

200. For statutory language regarding feasibility, see 11 U.S.C. § 1129 (1982 & Supp. II 1984).

201. *Id.* at 420; *see also* Fossum v. Fed. Land Bank (*In re Fossum*), 764 F.2d 520, 522 (8th Cir. 1985) ("debtors must realize that reorganization is simply not possible and [that] liquidation is the only feasible solution").

202. *Clarkson*, 767 F.2d at 420.

tinue to operate the business while in reorganization.<sup>203</sup> After enunciating the standard, the court affirmed the dismissal of the debtor's petition for reorganization based on the lack of reasonable likelihood of rehabilitation and the erosion of the creditors' positions.<sup>204</sup>

### CONCLUSION

During the eighteen month period between July 1984 and January 1, 1986, several significant developments occurred in the area of bankruptcy law. The Eighth Circuit issued opinions in such controversial topics as fraudulent conveyances, adequate protection and apportionment between dischargeable and nondischargeable debt. The court declined to follow the national trend by holding that for a debt to be held nondischargeable on grounds of intentional and malicious conversion, it must be shown that the debtor acted with actual malice and intent to cause harm. The court also addressed the issue of lien avoidance by a former spouse on the former marital homestead.

The area of bankruptcy is expanding rapidly, and consequently, the law is changing with that expansion. The general practitioner, as well as the bankruptcy expert, must keep abreast of the area in order to fully advise clients on a wide variety of matters.

*Michael C. Krikava*

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203. *Id.*; see *In re Great Northern Protective Services, Inc.*, 19 Bankr. 802, 803 (Bankr. W.D. Wash. 1982).

204. *Clarkson*, 767 F.2d at 420. Similarly, in *Prudential Ins. Co. v. Monnier (In re Monner Bros.)*, 755 F.2d 1336 (8th Cir. 1985), the court of appeals noted that a lower court determination on the issue of feasibility of a plan must be affirmed unless it can be shown that the determination was clearly erroneous. *Id.* at 1341. The court noted that "(i)n determining whether (a plan) is feasible, the bankruptcy court has an obligation to scrutinize the plan carefully to determine whether it offers a reasonable prospect of success and is workable." *Id.* (citing *United Properties, Inc. v. Emporium Dep't Stores, Inc.*, 379 F.2d 55, 64 (8th Cir. 1967)). The court found that the bankruptcy court had examined all of the relevant evidence of the case and determined that the plan was feasible. *Id.* We have carefully reviewed the record, and cannot say that the feasibility finding . . . was clearly erroneous." *Id.*